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ABSTRACT

The Student Text and Teacher's Guide examine the government's role in the U.S. economy and how the choices made by the government in Washington affect each individual. The student text is divided into four chapters. Chapter 1, "Government's Role in the Economy," discusses why government gets involved in the economy and examines the social and economic goals the government tries to achieve. Chapter 2, "How Government Affects the Economy," focuses on how government monetary, fiscal, and trade policies affect the economy. Chapter 3, "The Federal Budget and the Economy," presents how the federal government raises and spends money and the process by which Congress and the president set the nation's financial priorities as they prepare the federal budget. Chapter 4, "Today's Choices, Tomorrow's Legacies," concludes with the federal budget and U.S. trade deficits and how these affect the economy. A glossary of economic terms and a 48-item further reading list conclude the book. The Teacher's Guide offers classroom activities and handouts to promote active learning and enhance student understanding of the materials covered in each chapter of the student text. Students also conduct research and process information about the future of economic policy. The guide also provides unit tests and answer keys to assist in developing comprhensive lesson plans or units of study. The Teacher's Guide is divided into four units corresponding to the chapters of the student text. (EH)

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The American Economy

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SECOND EDITION

The American Economy

GOVERNMENT'S ROLE, CITIZEN'S CHOICE

CLOSE UP PUBLISHING

Close Up Foundation
Stephen A. Jarger, President

The Close Up Foundation is a nonprofit, nonpartisan educational foundation dedicated to encouraging citizen involvement in government. Throughout the year, the Close Up Foundation conducts a Washington-based seminar program that brings high school students, teachers, and older Americans to the nation's capital for weeklong, on-site learning experiences. Since 1971, more than 380,000 people have participated in the Close Up Washington experience.

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Introduction

I have no doubt that the democratic institutions of the United States, joined to the physical constitution of the country, are the cause of the prodigious commercial activity of the inhabitants.
Alexis de Tocqueville—author of *Democracy in America*

Alexis de Tocqueville, a young French nobleman writing about his travels in America in 1831-32, was most impressed with two aspects of the young republic: the democratic government and the ambition of Americans to be successful. Most American citizens, then as now, pursued individual economic goals while savoring the advantages of living in a democracy—all the time realizing that the two were interconnected and dependent on each other for success.

Throughout history, it has been the people of the United States who have played the major role in developing the economic system of their nation. They are the workers, the producers, and the consumers, and by their actions, they directly affect the economy of the whole nation. Those same producers and consumers are also voters in the American democracy. They elect the representatives who make the important decisions about the economy of the United States—decisions that will directly affect the citizens who elected them. Should taxes be raised or lowered? Should businesses be regulated or deregulated? Should tariff barriers be raised or lowered? The decisions—or choices—made by the policymakers in Washington go far in determining the economic well-being of the nation and its citizens. For these reasons, understanding the U.S. economy is vital to effective citizenship.

The following pages will examine the government's role in the U.S. economy and how the choices made by the government in Washington affect each American. Chapter 1 discusses why government gets involved in the economy and examines the social and economic goals the government tries to achieve. The chapter also looks at how the government's role in the economy has changed over the years. Chapter 2 focuses on how government monetary, fiscal, and trade policies affect the economy. How the federal government raises and spends money and the process by which Congress and the president set the nation's financial priorities as they prepare the federal budget are the topics of Chapter 3. Chapter 4 examines the federal budget and U.S. trade deficits and how these affect the economy.

Choices made by individual wage earners, businesspersons, and consumers affect the economy of the United States, just as choices made by federal government officials affect the well-being of each American. Effective citizens—because of their knowledge of the American economic system—will make wise choices and, through their vigilance, demand that their elected officials do the same. This book will supply a part of that knowledge.

1

Government's Role in the Economy

The Congress shall have Power To lay and collect Taxes, Duties, Imposts and Excises, to pay the Debts and provide for the common Defence and general Welfare of the United States; but all Duties, Imposts and Excises shall be uniform throughout the United States.

To borrow Money on the credit of the United States;

To regulate Commerce with foreign Nations, and among the several States, and with the Indian Tribes; . . .

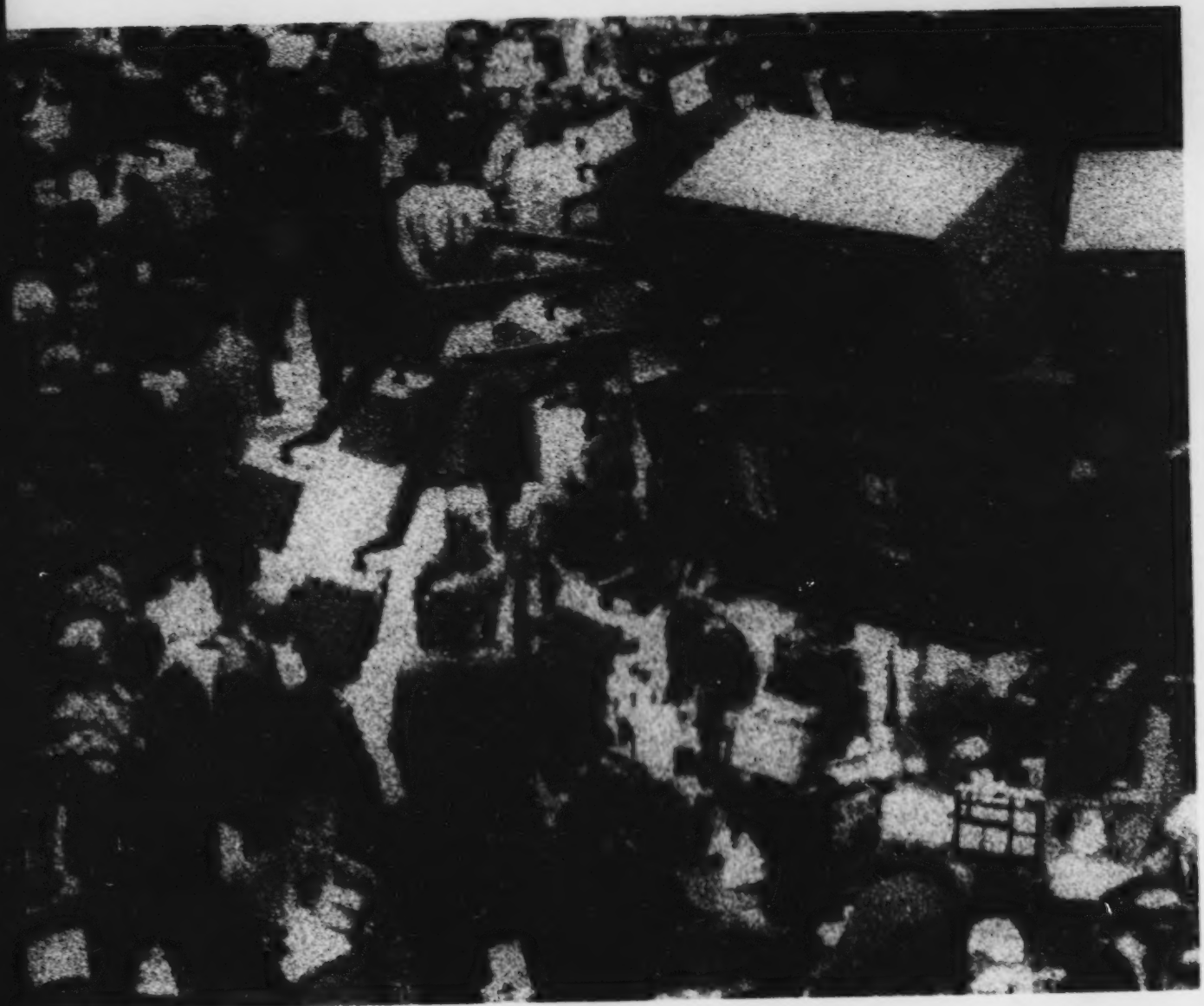
To coin Money, regulate the Value thereof, and of foreign Coin, and fix the Standard of Weights and Measures; . . .

Constitution of the United States—Article I, Section 8

The framers of the Constitution devoted few words to the role of the government in the economy of the young nation, preferring to limit such references to taxation, spending and borrowing, coining money, and regulating commerce. Those early Americans were content to allow the people to pursue their economic goals as they saw fit.

However, as the decades went by, the federal government expanded its role in the nation's economy, often in response to events such as wars, recessions, depressions, or concerns over poverty. As these and other events occurred, the government reacted by raising or lowering taxes, erecting tariffs or trade barriers, or regulating business more closely. And, as with most government policies, a certain percentage of the population questioned the government's actions.

Today is no exception. Americans still question the government's role in the economy. Some think the role is too large, demanding lower taxes, less spending, and fewer rules and regulations. Others want the government to do more—



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raise taxes, increase spending, eliminate poverty, or increase the regulation of businesses and corporations. But whichever side prevails, the fact remains that the federal government has always played some role in the economy—a role that has grown progressively larger over the years.

This chapter examines why the federal government gets involved in the economy and how government actions can affect individuals, small businesses, and large corporations. The chapter also discusses the economic functions of American government, traces the involvement of the government in the economy, and examines how Americans' views of the government's proper role in the economy have changed over the years.

Why Government Gets Involved

The United States is a country rich in *natural, human,* and *capital resources.* It has vast amounts of raw materials, large numbers of workers with a variety of skills, and numerous factories and machines. Yet even in the United States, there are not enough resources for people to have everything they want or need. This situation, called *scarcity,* forces Americans to make certain decisions about their own economic well-being. These decisions can be called "economic choices." Individual Americans make economic choices that they think will do them the most good—that is, they decide what to buy, what to sell, how much to spend, how much to save, and so forth.

In the United States, people make economic choices every day by being the workers, the producers, and the consumers in America's economy. But there is another player in the U.S. economy—the government—that plays an important role (figure 1.1). For instance, the government protects workers by establishing job safety standards. Consumers rely on federal and state laws requiring products to be safe. And businesses and individuals benefit from basic support services that government provides, such as police and fire protection.

Just like individuals, the government makes economic choices, such as how much money it will spend on AIDS

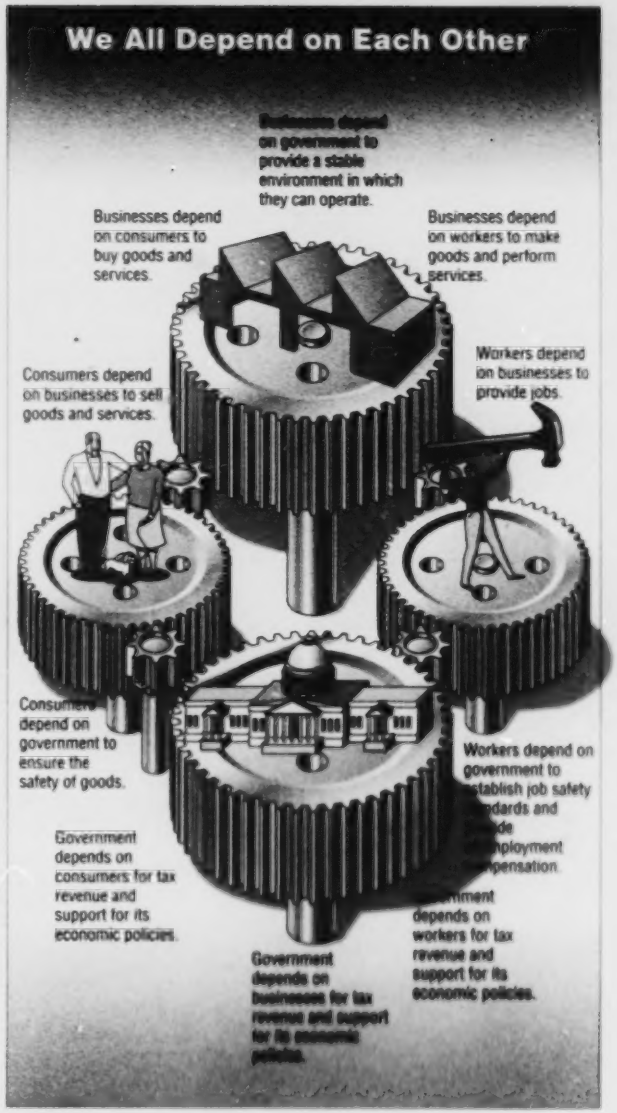
We All Depend on Each Other
Businesses depend on government to provide a stable environment in which they can operate.
Businesses depend on consumers to buy goods and services.
Businesses depend on workers to make goods and perform services.
Consumers depend on businesses to sell goods and services.
Workers depend on businesses to provide jobs.
Consumers depend on government to ensure the safety of goods.
Workers depend on government to establish job safety
dards and
ployment
pensation
Government depends on consumers for tax revenue and support for its economic policies.
ment
depends on workers for tax revenue and support for its economic policies.
Government depends on businesses for tax revenue and support for its economic policies.

Figure 1.1

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research, how much tax revenue needs to be collected in a given year, or what programs will receive what level of funding. But whereas the choices made by individuals affect only themselves, the economic choices made by the government affect everyone. Even though not everyone always agrees with the choices made by the government, most people are willing to concede that certain rules and policies are necessary to avoid chaos.

The government takes on this leadership role because it is the only institution that has the authority to focus on the needs of society as a whole. Only the government has the power to establish the rules that ultimately will provide for the common good. It provides the basic framework in which economic activity takes place. And it is within this framework that government officials, corporate executives, small business owners, and individual citizens make choices that affect the economy.

Economic Goals

At the heart of the government's involvement in the economy is its desire to achieve the nation's economic goals (figure 1.2). For example, the government seeks to provide economic security for its citizens. Economic security means protecting Americans from economic risks they cannot control, such as bank failures and job layoffs. Thus, federal government agencies insure bank deposits to protect people from losing their savings and provide unemployment compensation to workers who have lost their jobs.

Government officials must choose which economic goals to emphasize at any given time because goals may conflict. For instance, many people think the government should provide food, clothing, and shelter to the needy, but to do this, government officials must collect money from some citizens to give to others. Consequently, Americans are not free to spend all of their money as they wish. Thus, the goals of economic equity—that is, what most Americans consider fair—and economic security may clash with the goal of economic freedom. Economic, social, and political conditions dictate which of the nation's goals policymakers decide to emphasize at a given time.

U.S. Economic Goals
Economic Growth
Raising the nation's standard of living.
Economic Stability
Achieving full employment and stable prices.
Economic Efficiency
Making the best use of resources to produce the most goods and services.
Economic Security
Protecting individuals from risks they cannot control.
Economic Freedom
Ensuring freedom of choice in the marketplace. Workers choose their own occupations, consumers decide how to spend their own money, and private businesses decide what and how much to produce.
Economic Equity
Making the economy fair. But people may disagree about what fairness means.

Figure 1.2

It may seem odd, but the government achieves its economic goals both by staying out of and by intervening in the economy. For example, the goals of economic efficiency—making the best use of the nation's resources—and economic freedom may be achieved if policymakers allow the econ-

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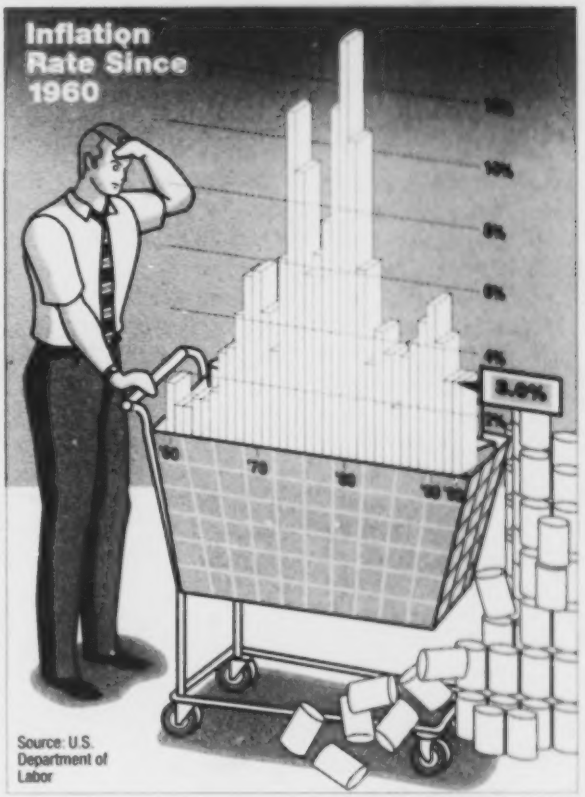
What Is Inflation?

Inflation is a continuing rise in prices for goods and services. The higher the rate of inflation, the faster prices go up. Inflation means that a dollar buys less than it used to. Unless individuals' incomes rise at the same rate as prices, their well-being decreases.

There are two major types of inflation. One is *demand-pull inflation*, which occurs when prices are pulled up by high demand. When the economy is growing, most workers are employed and businesses are doing well. People have money to spend, and they are able to purchase all the goods and services produced. Eventually, there are more people who want to buy than there are products to go around. Thus, prices are bid up, because consumers and businesses are willing and able to pay more money to get what they want or need.

A second type of inflation is *cost-push inflation*. This type of inflation occurs when prices are pushed up by high production costs, rather than pulled up by an increase in demand for goods and services. When the cost of making goods goes up, businesses increase the prices consumers have to pay. For example, when the price of oil went up in the 1970s, so did the price of all petroleum-based products, such as agricultural chemicals, plastics, and synthetic fibers. It may also cost businesses more to produce the same goods if employees negotiate large wage increases. The cost of wage increases is usually passed on to consumers in the form of higher prices.



omy to operate freely. Most experts agree that a *market* or *capitalist economy* like that of the United States tends to be efficient because resources are put to their best uses and the products that consumers want most are made. Capitalist economies also allow a great deal of flexibility. People in the United States can pursue their own interests in the economy. For example, consumers can choose the *goods* (tangible products such as pizzas, VCRs, and cars) and *services* (actions performed for a fee, such as babysitting, banking, and computer programming) they want to buy or use, workers can choose the job that will pay them the most money, and businesses can sell the products that will make them the highest profit.

However, at the same time, the government may achieve the nation's economic goals by getting involved in the economy. For instance, although a market economy is efficient, it allows some people to lose their jobs and be poor. To

achieve the goals of economic equity and economic security, the government aids needy Americans through social programs such as Aid to Families with Dependent Children (AFDC) and food stamps. The government also becomes involved in the economy to promote *economic growth* (increased production) and economic stability. Left alone, the economy experiences extreme highs and lows; therefore, government officials intervene to smooth out wide swings in business activity.

Economic Functions of Government

The government performs six separate functions in the U.S. economy. These include

1. providing a stable environment in which economic activity can take place;
2. maintaining competition in the economy;
3. redistributing income;
4. reducing the negative side effects of economic activities;
5. providing certain goods and services; and
6. stabilizing the economy.

Federal, state, and local governments share the first five functions. However, stabilizing the economy is solely the responsibility of the federal government because only the federal government can deal with issues that affect the nation as a whole.

Providing a Stable Environment

The government provides a stable environment in which economic activity can take place. It does this in two ways. First, government officials make and enforce the "rules of the game." Such rules define and protect the rights of consumers, workers, and businesses. For example, the government protects private property, enforces contracts, and punishes fraud. Without this involvement, the economy would be like a football game played without rules or referees. Individuals would disagree about what constitutes fair play. And even if players agreed on rules, not everyone would follow them without enforcement. By serving as rulemaker and referee, the government helps the economy run efficiently.

Bureau of Engraving and Printing

Providing a national currency is one of the many ways the U.S. government helps the economy operate smoothly.

A second way that the government maintains a stable environment for business activity is by providing basic services the economy needs to operate. For instance, for the economy to operate smoothly, everyone in the country must use the same system of money. Officials in Washington have established a national currency to help people exchange goods and services. Similarly, officials provide a system of standards for measuring the weight and quality of products throughout the nation. Such standards guarantee, for example, that a one-quart milk carton in New York contains the same amount of milk as a one-quart carton in California. Government services such as these promote economic activity by increasing public confidence in the economy.

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Maintaining Competition

Another government function is to maintain competition in the economy. Competition is the economic rivalry among businesses for consumers' dollars. Businesses get consumers' dollars by selling the products that consumers want at the lowest possible prices. Competition is what makes the market economy efficient. However, sometimes a business grows so strong that it pushes out its competitors. This situation, in which only one business makes or sells a product, is called a *monopoly*. A business with a monopoly can raise the price of its product, allowing the business to enjoy higher *profits* (income after expenses). Because other businesses do not sell the product, consumers must either pay the higher price or go without the product.

In the United States, the government pursues the goal of efficiency by maintaining competition. In the case of "natural monopolies"—industries where competition is impractical or impossible—policymakers set up public commissions or boards to regulate prices and set service standards. Local utilities are examples of natural monopolies. Instead of having two or more local electric companies, each with its own power lines, it is cheaper to have only one. Thus, the government gives the electric company the exclusive right to serve a specific area, but in return, the company must abide by the rules and regulations set by the public commission.

Another way that government maintains competition is by making and enforcing laws forbidding monopolies. Such laws are called antitrust laws. The government uses antitrust laws to break up existing monopolies and prevent the creation of new monopolies in industries where competition is possible. For example, in 1984 the federal government ended the monopoly of American Telephone & Telegraph (AT&T) on the nation's telephone business by forcing AT&T to allow other companies to provide telephone service.

Redistributing Income

The government redistributes income among citizens to achieve the goals of economic equity and economic security. America has long been called the "land of opportunity" because its economic system can reward individual initiative with great wealth. However, the U.S. economy sometimes punishes lack of success with low incomes and even poverty. Many Americans consider it unfair that the poorest 20 percent of families receive 5 percent of the nation's income, while the richest 20 percent of families receive 43 percent of the nation's income. Thus, federal officials try to redivide the economic pie so that all Americans will have the basic necessities of food, clothing, and shelter.

The government redistributes income by taking money from some Americans and giving it to others. One way the government does this is through *transfer payments*, which are gifts of money, rather than payments made in return for goods or services. Social Security benefits, for example, collect money from younger, working people to support older, retired people. Similarly, unemployment compensation transfers income from the employed to the unemployed.

Government officials also raise the incomes of certain Americans by changing the prices established by markets. Most prices in the United States are determined by how much of an item is available (*supply*) and how much of an item people are willing and able to buy (*demand*). But in some cases, policymakers set prices higher than the free market itself would pay. For instance, minimum wage laws raise workers' incomes by guaranteeing employees a wage that is likely higher than employers on their own would pay. Similarly, federal policy guarantees wheat growers a higher price for their crops than buyers would usually pay in the market.

Reducing Negative Side Effects

Another government function is to minimize the sometimes harmful side effects of economic activities. Examples of negative side effects include pollution, traffic congestion, and soil erosion. The government intervenes in the economy to deal with undesirable side effects in three ways.

First, Congress passes laws that prohibit or limit negative side effects. The Clean Air Act of 1990, for instance, called for sharp reductions in smog and toxic emissions that cause air pollution.

Such laws are enforced by a variety of government agencies, including the Environmental Protection Agency (EPA).

Second, the government taxes business activities that have negative side effects. By charging companies for the harm they do, the government discourages negative behaviors. For example, it can tax polluters and then use this money to clean up the environmental problems they caused.

Third, the government attempts to minimize the negative side effects of economic activity through *subsidies*. Subsidies are government payments to promote certain activities. Subsidies can take the form of low-interest loans, cash payments, or tax breaks. To reduce pollution, for example, the government can subsidize the construction of factories that pollute less than existing factories.

Providing Public Goods

The government also provides goods and services—called *public goods*—for society as a whole. Highways, schools, and police and fire protection are examples of public goods. The government provides public goods when the market economy fails to produce any or does not produce enough of certain goods and services that Americans want. This happens because public goods are so large and expensive that they cannot be bought by individual consumers. For instance, an interstate highway cannot be divided up and sold to drivers.

Public goods are used by society as a whole. People (such as children) who do not pay for public goods cannot be prevented from using them. National defense is an example of a public good. If national defense is provided for one American, all other citizens can benefit from it at the same time. Also, once in place, the nation's defense system protects everyone—even those who do not pay for it.

Stabilizing the Economy

Government actions can help stabilize the economy. Without government help, the economy is like a rollercoaster. It experiences sharp highs and lows, called the *business cycle*. When the economy is growing, businesses expand, more workers are hired, and consumers have more money to spend. Because businesses and consumers are spending more, prices can be pulled up by high demand. When the economy slows, businesses fail, workers lose their jobs, and consumers have less money to spend. This slowdown in economic activity is called a *recession*. A severe and long-lasting recession is known as a *depression*. The government intervenes in the economy to promote stable prices, full employment, and steady growth.

Retired Americans receive money from the federal government so that they can afford goods and services.

Today, federal, state, and local governments perform a variety of important economic functions. But the role of government—particularly the federal government—in the economy has changed dramatically during the nation's history. These changes reflect shifts in the relative importance of the nation's economic goals.

The Changing Role of Government in the U.S. Economy

Since the founding of the United States, the federal government has gradually expanded its involvement in the economy. Until

the 1880s, the actions of the government in Washington were largely limited to supporting economic development. For example, federal decisionmakers gave land grants that promoted settlement of new territories; helped finance construction of highways, canals, and railroads; and erected trade barriers to protect new U.S. industries from foreign competition. With Washington's help, America changed from an agricultural nation to a major industrial power during the nineteenth century.

Because economic freedom was the top priority in the 1800s, the federal government rarely put restrictions on business. Instead, it adopted a *laissez-faire* position toward the economy. (*Laissez-faire* is a French term meaning "leave it alone.") This limited role for government was supported by Scottish economist Adam Smith, who wrote *The Wealth of Nations*. According to Smith's theory, individuals, if left to pursue their own economic interests without interference by the government, would be led by an "invisible hand" to do what was best for society. For example, to win consumers' money, businesses would sell the products that consumers wanted most.

Library of Congress

Many children worked in factories during the 1800s. To prevent harmful practices such as child labor, the federal government began regulating the conduct of business.

Beginnings of Government Intervention

However, by the second half of the nineteenth century, unrestricted freedom for business had a variety of destructive consequences. Wealthy industrialists merged competing companies, thereby controlling entire industries such as oil and steel. These monopolies charged consumers higher prices. Irresponsible management in industries vital to the rest of the nation—such as banking and railroads—caused businesses to fail. Many workers were poorly paid and worked under unsafe conditions. They were often laid off during business slowdowns.

Because the decisions made by individual business owners had such a negative impact on the rest of society, state governments began to regulate business. However, state laws were unable to control companies that operated in many states. Thus, federal officials responded to public pressure for a more equitable and secure economy by setting new ground rules for the conduct of business.

Between 1887 and World War I, the federal government passed several major pieces of legislation to regulate business. In 1887, the Interstate Commerce Act made it illegal for railroads to charge more for a short haul than for a long haul on the same line and prohibited kickbacks to favored customers. The act also created the first federal regulatory agency, the Interstate Commerce Commission (ICC), to administer the new law. In 1890, the Sherman Antitrust Act outlawed monopolies. The Federal Trade Commission Act of 1914 established the Federal Trade Commission (FTC) to prevent unfair business practices such as false advertising and *price-fixing* (colluding to set the price of a product). The Clayton Antitrust Act of 1914 outlawed certain business practices that led to monopolies.

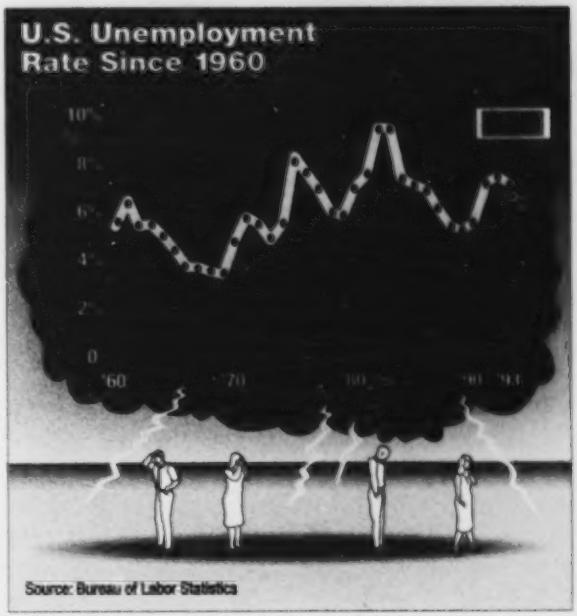
During this period, Congress and the president also enacted laws designed to protect consumers and improve working conditions. The Pure Food and Drug Act of 1906 required companies to label the contents of foods and medicines. The Workmen's Compensation Act of 1916 provided assistance to disabled federal employees. And the Adamson Act of 1916 established an eight-hour workday and overtime pay for railroad workers. These and other

What Is Unemployment?

Unemployment refers to the number of people who are looking for work but cannot find jobs. Because there are always people between jobs, the unemployment rate is never zero. According to most economists, the economy has *full employment* when only 4 percent of the labor force is looking for work.

There are four major types of unemployment:

- Frictional—unemployment that occurs when people are between jobs or entering or reentering the job market for the first time.
- Seasonal—unemployment that results from seasonal or weather-related changes in demand for certain products.
- Cyclical—unemployment that occurs because of downturns in the economy.
- Structural—unemployment that results from changes in the economy, making the skills of certain workers obsolete.



Unemployment statistics can be misleading for several reasons. The figures may understate the extent of unemployment because they do not include people who have given up looking for work, people who want to work full-time but are only able to find part-time jobs, or people who are working below their level of skills and education. On the other hand, unemployment figures may be overstated because of false information. For example, people who have illegal jobs, such as selling drugs, may claim to be unemployed to avoid paying taxes and being arrested. Also, some people who do not want to work may claim to be unemployed so that they can collect unemployment compensation.

pieces of legislation marked a major change in the federal government's role in the economy.

World War I slowed federal efforts to regulate businesses and protect workers and consumers. Instead, the federal government worked closely with businesses during the war to meet production goals. This cooperative relationship between the federal government and business continued after the war ended. Throughout the prosperous 1920s, the goal of economic freedom was dominant once again.

The Great Depression

The year 1929 marked the beginning of an economic disaster. With the collapse of the New York stock market on October 29, the nation plunged into the Great Depression. Thousands of businesses were ruined, and millions of Americans were left unemployed. President Herbert Hoover's efforts to deal with the depression were insufficient.

In 1932, Franklin Roosevelt was elected president, promising a "new deal" for all Americans. Thus began the rapid

Library of Congress

In 1932, with nearly one-fourth of the nation's workers unemployed, millions of Americans faced poverty and hunger.

expansion of the federal government's role in the U.S. economy (figure 1.3). President Roosevelt responded to Americans' pleas for economic equity, security, and growth. He used the principles of British economist John Maynard Keynes to try to lift the country out of the depression. Keynes argued that economic depressions are caused by insufficient demand for goods and services and that only the government could move an economy out of a depression by cutting taxes and/or spending more money. Reduced taxes and higher government spending pump more money into the economy for businesses to invest and for consumers to spend. Keynes thought that consumers and businesses by themselves did not have enough money to stimulate the economy.

The Roosevelt administration spent large amounts of money, much of it borrowed, to put people back to work. Many people were paid by the government for public works jobs such as repairing roads and building bridges. Other Americans received unemployment compensation and retirement benefits. The New Deal theory was that people with money in their pockets would revitalize indus-

Figure 1.3, The Changing Role of Government in the U.S. Economy

▼ The Great Depression

Franklin D. Roosevelt Library

1933—President Franklin Roosevelt's New Deal programs greatly expand the federal government's role in the economy.

1933—The Glass-Steagall Act reforms the banking system and establishes the Federal Deposit Insurance Corporation (FDIC) to insure individual bank deposits.

1934—The Federal Securities Act sets up the Securities and Exchange Commission (SEC) to oversee the operation of stock markets.

1934—The Federal Communications Commission (FCC) is established to regulate interstate and foreign communications by telegraph, cable, and radio.

1935—The Social Security Act establishes a system of pensions and survivors' benefits.

1938—The Fair Labor Standards Act establishes a minimum hourly wage and maximum workweek, guarantees time-and-a-half pay for overtime, and forbids child labor.

▼ World War II and the Postwar Era

1941—During World War II, the federal government assumes special economic powers, including rationing goods, setting production goals for the defense industry, and establishing wage and price controls.

1946—The Employment Act states that it is the federal government's responsibility to manage the economy.

▼ The Great Society

1963—The Equal Pay Act guarantees equal pay to those doing the same or similar work, regardless of sex.

Lyndon B. Johnson Library

1964—President Lyndon Johnson calls for a war on poverty.

1964—The Civil Rights Act outlaws job discrimination based on race, sex, religion, or national origin.

1967—The Age Discrimination Act protects workers between the ages of 40 and 65 against age discrimination.

try by demanding more goods and services and that, when the economy recovered, increased tax revenues would let the federal government repay the money it had borrowed. Although New Deal programs helped many Americans, it was the industrial growth brought on by World War II that ended the Great Depression. However, the federal government remained in debt after the war was over.

Post-World War II Era

After World War II, the government in Washington continued to play an active role in the economy. Most Americans agreed that it was the federal government's responsibility to promote economic equity, security, stability, and growth. This new consensus was confirmed in the Employment Act of 1946, which stated that it was the federal government's duty to maintain "maximum employment, production, and purchasing power."

During the 1950s, however, President Dwight Eisenhower and the Republican-controlled Congress tried to reduce the federal role in the economy. The president and Congress limited federal spending and transferred some responsibilities to the states. The Eisenhower administration believed that efficiency and freedom were the most important economic goals.

In the 1960s, equity and security again became major economic goals. President Lyndon Johnson and Congress dramatically expanded the federal government's responsibility for ensuring the well-being of Americans. President Johnson declared a "war on poverty" and proposed a number of federal programs that would create, in Johnson's words, a "great society." The Great Society programs were designed to reduce poverty, provide job training, and guarantee basic necessities such as food and medical care. However, heavy government spending on these social programs and the Vietnam War pumped too much money into the economy, fueling *inflation* (rising prices).

During the 1970s, Presidents Richard Nixon, Gerald Ford, and Jimmy Carter tried to promote economic growth and stability. However, *unemployment* (joblessness) and inflation skyrocketed after the 1973 Arab oil embargo and further oil price hikes in 1974 and 1979. Long dependent on cheap

The Changing Role of Government in the U.S. Economy, continued

▼ The 1970s

1970—The Occupational Safety and Health Administration (OSHA) is established to administer federal laws protecting workers from on-the-job hazards.

1970—The Environmental Protection Agency (EPA) is created to oversee federal regulation of the environment.

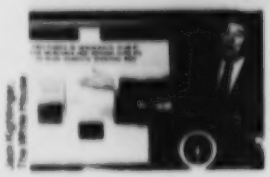
1971—President Richard Nixon introduces wage and price controls to combat inflation.

1972—The Consumer Product Safety Commission (CPSC) is established to protect the public from dangerous goods.

1974—The Nuclear Regulatory Commission (NRC) is created to license and supervise civilian nuclear plants.

1978—The Carter administration phases out federal regulation of the airline, trucking, natural gas, and oil industries to encourage competition and lower prices.

▼ Reaganomics



Jack Kightlinger, The White House

1981—President Ronald Reagan institutes "supply-side" economics by cutting taxes.

1981—The national debt reaches $1 trillion.

1986—President Reagan and Congress reform the income tax system.

1987—President Reagan introduces the first trillion-dollar budget.

▼ The 1990s

Clinton for President Campaign

1993—President Bill Clinton and Congress approve a package of tax increases and spending cuts totalling $500 billion in deficit reductions over four years.

1994—President Clinton and Congress consider proposals to reform the nation's health care system. Health care spending accounts for more than 14 percent of U.S. gross domestic product.

sources of energy, industries laid off workers and passed their increased energy costs on to consumers. High inflation, high unemployment, and slow growth plagued the economy throughout the decade.

By 1980, many Americans were ready for a new approach to economic policy. The Keynesian idea that government should use its taxing and spending powers to manage the economy had guided U.S. economic policy since the Great Depression. Yet the *stagflation* of the 1970s, which combined a stagnant (nongrowing) economy with inflation, caused many to question or reject the theories of Keynes.

"Reaganomics"

In 1981, Ronald Reagan brought a new economic philosophy to the White House. President Reagan vowed to "get the government off the backs of the people" by limiting the federal government's role in the economy. The Reagan administration focused on achieving the national goals of economic efficiency and freedom.

President Reagan's economic policy, called *supply-side economics*, aimed to raise employment and lower inflation by increasing the supply of goods and services in the economy. The Reagan administration, with the support of Congress, implemented this plan by cutting taxes on personal and corporate income, decreasing federal spending on social programs, and reducing government regulation of business.

In 1981, Congress responded to President Reagan's call for lower taxes by passing the largest tax cut in U.S. history. Lower taxes, the president believed, would put more money in people's pockets, encouraging Americans to work, save, and invest more. Businesses would hire more workers and make more products, reducing unemployment and inflation. And, as prosperity returned, tax revenues would increase, offsetting the tax cut.

In addition, Congress, acting on the Reagan administration's suggestions, cut funding for some domestic programs. Proponents of supply-side economics argued that social programs increase the tax burden on workers and business and the federal government's debt. Many supply-siders also believed that social programs such as unemployment compensation undermine incentives to work.

The Reagan administration also tried to abolish or weaken federal regulations designed to protect workers, consumers, and the environment. President Reagan argued that the high cost of obeying federal health and safety laws and pollution controls added to the price of goods. He believed that fewer government regulations on business would reduce the cost of goods to consumers and would make American goods more competitive in world markets. The president also claimed that businesses would invest the money they had previously spent to comply with costly federal regulations. Greater investment would increase businesses' production and encourage economic growth.

The results of "Reaganomics" were mixed. From late 1981 to early 1983, the country experienced its worst recession since the Great Depression. Unemployment reached almost 10 percent, the highest level since 1932. However, inflation was brought under control, and from 1983 to 1990, the U.S. economy experienced its longest peacetime expansion in history.

1990s

When President George Bush took office in 1989, he pledged to continue the policies of his predecessor Ronald Reagan. The new president did not seek to reduce the federal role, but he opposed adding to the federal government's economic responsibilities. President Bush emphasized the importance of states, businesses, and individuals, rather than the government in Washington, in promoting economic equity and security. He believed that the federal government should fund experimental economic programs in states. States would serve as laboratories and would be responsible for funding the projects that worked.

However, the Bush administration entered the 1990s having to contend with several economic problems—among them a crisis in the savings and loan industry and a recession. Hundreds of savings and loan companies throughout the nation were forced to close or merge because of massive

What Is Economic Growth?

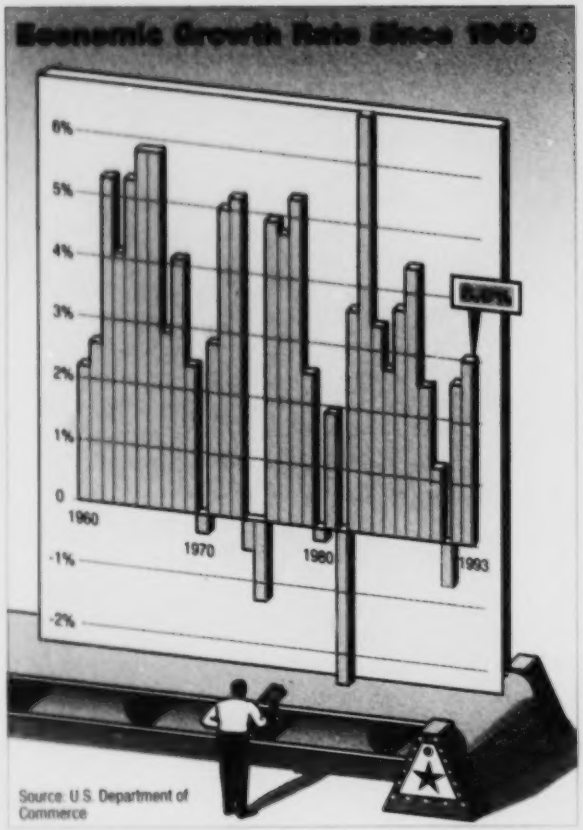
Economic growth is a major goal of the U.S. economy. Economic growth means that the economy produces more goods and services per person in one year than it did the previous year. Economic growth occurs when gross domestic product (GDP) increases over time. GDP is the total national output of goods and services. In 1993, GDP rose at an average of 2.8 percent more than the previous year.

Several factors contribute to economic growth. First, increases in the quantity of and improvements in the quality of natural resources, such as oil and timber, fuel economic growth. Second, increases in the number of and improvements in the quality of workers help the economy grow. Third, expanding the number of and improving the quality of the nation's machines and factories cause economic growth. Fourth, technological advances encourage economic growth by allowing the economy to produce more with the same amount of resources.

Economic growth benefits the United States in several ways. First, economic growth improves the *standard of living*, or material well-being, of Americans. When the economy grows, jobs are created and salaries increase. Americans can afford more and better material comforts—bigger homes, fancier cars, and better clothing.

Finally, a growing economy means that there are more taxpayers and many people are paying higher taxes. This increase in revenue gives the government more money to pursue its domestic and international goals. These goals might include maintaining a strong national defense, providing a wide variety of social programs, and aiding friendly governments around the world.

However, economic growth also involves certain costs. Economic growth may harm the environment, causing pollution and using up natural resources that cannot be replaced. Another drawback to economic growth is that it makes the skills of some workers obsolete. Finally, some economists criticize economic growth because its benefits are not shared equally among Americans. For example, economic growth has not eliminated poverty.



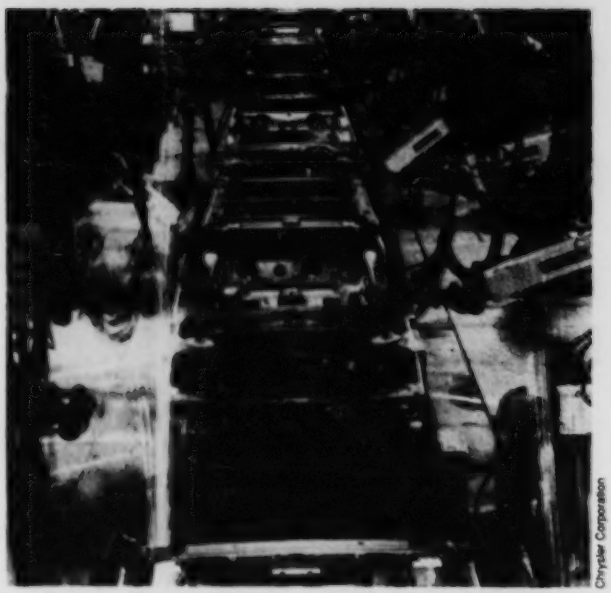
debts they had accumulated through bad loans and investments. Some experts blamed the failure of the thrift industry on the deregulation policies of the Reagan administration. Others claimed that the fault lay not with a lack of rules and regulations but with poor scrutiny by government examiners and auditors whose job it was to spot unwise and illegal practices. And some observers blamed poor management by savings and loan officials themselves for the failures of their institutions.

In 1990, the United States, following eight years of economic expansion, went into a recession. U.S. manufacturers produced fewer goods, consumers spent less money, and many workers lost their jobs. Economists blamed the slowdown on continuing budget and trade deficits and increased energy costs brought about by the war in the Persian Gulf.

Although the recession ended in the spring of 1991, the recovery would be slow and painful for the next two years. Economic growth in late 1991 and 1992 was weak and failed to produce jobs and install confidence in businesses and consumers. The majority of Americans wanted the federal government to take a more active role in creating economic prosperity. However, President Bush believed that excessive federal intervention was the wrong medicine for an ailing economy.

In 1992, Bill Clinton defeated President Bush in the presidential election by promising to "focus like a laser beam" on the American economy. President Clinton promised to invest money in job training and education to help American workers and companies to compete in the twenty-first century. In what most experts called a dramatic reversal of "Reaganomics," the president and Congress passed a sweeping deficit reduction package of large tax increases and spending cuts in 1993. In addition, the Clinton administration called for a greater federal role in reforming the nation's health care system. Overall, most experts believe President Clinton favors a more activist role for the federal government in the American economy.

In late 1993 and 1994, the U.S. economy grew at a steady pace and the unemployment rate decreased. Most economists predicted that 1994 would be the best year for the American economy since 1988. However, many experts believe that the full impact of President Clinton's economic program will not be felt until 1995 or 1996.


Chrysler Corporation

A surge in domestic sales of American-made automobiles helped fuel the U.S. economy's recovery in 1993 and 1994.

Although most Americans are more confident today about the economy, the nation remains divided over the proper role of government in a free economy. Some people argue that only the federal government has the resources to deal with national problems such as pollution and poverty. Others say that government interference in the economy makes it less productive, and thus diminishes the well-being of the people.

The future role of Washington policymakers in the economy will reflect the values of most citizens. Americans will have to decide what the nation's most important economic goals are and what economic choices they want the government to make for them.

2

How Government Affects the Economy

Our system is depressive-manic;
It runs to boom, or else to panic.
In view of this it would be wise
For government to stabilize—
Remembering the need for both
Stability and steady growth,
And that inflation dulls the enjoyment
Even of constant full employment.
Kenneth Boulding—American economist

The U.S. economy has grown tremendously over the years. That growth, however, has not been steady. Periods of slow business activity have followed periods of prosperity. Without government help, the economy has swung between widespread unemployment and inflation. Since the 1930s, the federal government has tried to stabilize the economy. It seeks to promote steady growth with full employment and stable prices.

The government has several powerful tools that it can use to influence economic conditions. These tools can be used to bolster an ailing economy as well as to prevent unhealthy trends from beginning. However, if used improperly, these tools can make a sick economy even sicker.

This chapter discusses the three policy tools the federal government uses to influence the economy:

1. *monetary policy*—which establishes the amount of money available in the economy;
2. *fiscal policy*—which determines government spending

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and taxation; and

3. *trade policy*—which regulates U.S. trade with foreign nations.

Making choices in the use of these policies involves much more than the "science" of economics. The use of each policy involves political issues, competing social values, and questions about the proper role of government in the economy.

Monetary Policy

Money is a vital part of the U.S. economy. It serves four important functions. First of all, money is society's *medium of exchange*. That is, people accept money as payment for goods and services. Without money, people would have to barter—or directly trade—one product for another. Secondly, money acts as a *standard of value*. This means that people can measure the relative value of different goods and services by comparing the prices of each. Money also functions as a *unit of account*, enabling people to keep records of the value of their property as expressed in terms of the U.S. monetary unit—the dollar. Finally, money acts as a *store of value*. In other words, people can save money for later use.

Every nation needs a consistent flow of money in its economy. Money allows consumers to buy goods and services. It enables businesses to pay their workers, build factories, and purchase machines. However, too much money in an economy can cause inflation. When people have more money to spend, they are willing and able to pay more for goods and services. As a result, prices rise. Economists call this situation "too much money chasing after too few goods." Likewise, too little money in an economy can lead to unemployment. When spending decreases, businesses cut back on production and lay off workers.

The federal government tries to promote steady economic growth without inflation or unemployment. One way that it does this is by regulating the *money supply*—the amount of money in the economy. This function, known as monetary policy, is entrusted to the Federal Reserve System.

Close Up Foundation/Renée Bouchard

The Federal Reserve determines the nation's monetary policy. The headquarters of the Federal Reserve (shown here) is located in Washington, D.C.

Federal Reserve System

Founded in 1913, the Federal Reserve System (also called the Fed) is the nation's central bank. The Fed is directed by a board of governors, whose seven members are appointed to fourteen-year terms by the president with Senate approval. All national banks must join the Federal Reserve System, but state banks can choose whether or not to join.

The Fed does not deal directly with the public. Instead, it acts as a "banker's bank," meaning that it provides several important services to U.S. banks. For example, the Fed processes checks and lends money to banks. It also serves as the federal government's bank, holding the government's cash deposits and issuing paper currency.

The most important task of the Federal Reserve is making the nation's monetary policy. The Fed decides what monetary policy to pursue, then increases or decreases the money supply to achieve its goal. For example, when unemployment is high and inflation is low, the Fed increases the money supply. Increasing the money supply causes *interest rates* to fall because banks have more dollars to lend. The interest rate is the price paid for borrowing money. Lower interest

rates encourage consumers to borrow money to buy expensive goods like cars, boats, and houses. Similarly, lower interest rates cause businesses to take out loans to build factories or buy computers. In this way, increasing the money supply stimulates economic growth.

Conversely, during periods of low unemployment and high inflation, the Fed decreases the money supply. With fewer dollars available to lend, banks increase interest rates. Higher interest rates make it more expensive to borrow money. As a result, consumers cut back on spending, and businesses invest less money, causing the economy—and inflation—to slow.

Tools of Monetary Policy

The Federal Reserve uses three tools to control the money supply (figure 2.1): (1) the reserve requirement; (2) the discount rate; and (3) open market operations.

Reserve Requirement. One way the Fed can influence the money supply is by changing the *reserve requirement*. The reserve requirement is the percentage of deposits that banks must keep on hand rather than lending. In other words, banks do not lend all the money that people deposit with them. For example, if the reserve requirement is 15 percent, and Ms. Davis deposits $100 in the First National Bank, her bank is required by the Fed to reserve 15 percent of the $100, but it can lend the other $85 to Mr. Jones. If the Fed lowers the reserve requirement to 10 percent, banks can hold a smaller portion of their deposits as reserves and lend a larger portion to consumers and businesses. When consumer spending and business investment increase, more workers are hired and the economy grows. Conversely, by raising the reserve requirement, the Fed forces banks to hold a larger share of their deposits as reserves. Banks must then cut back on their loans. With less money available for consumer spending and business investment, inflation falls but unemployment rises.

Discount Rate. A second way the Federal Reserve regulates the money supply is by altering the *discount rate*—the interest rate that the Fed charges banks for the use of its

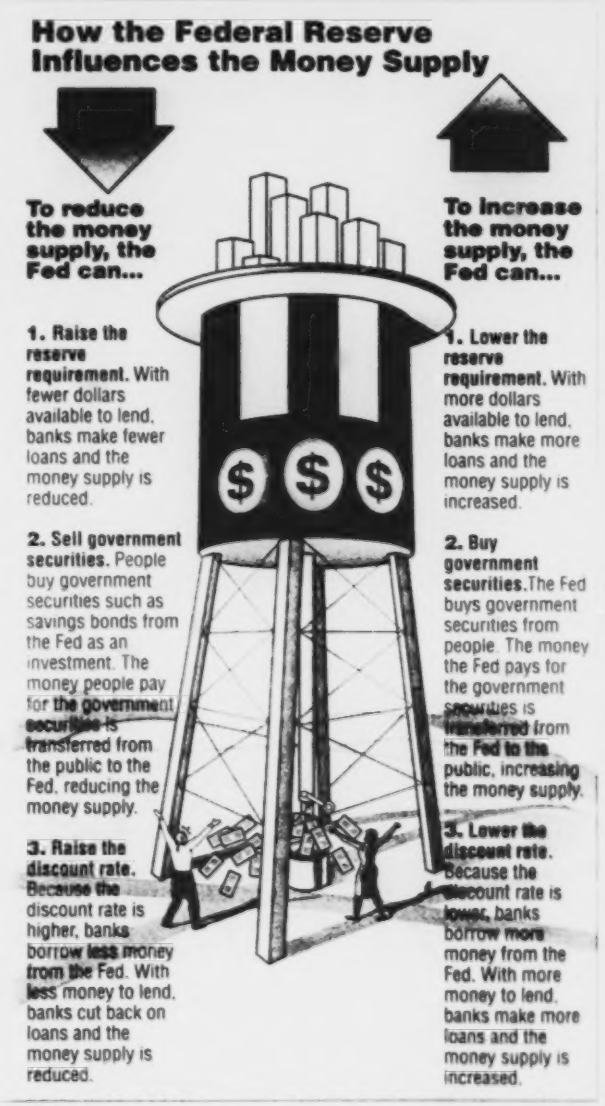
How the Federal Reserve Influences the Money Supply
To reduce the money supply, the Fed can...
1. Raise the reserve requirement. With fewer dollars available to lend, banks make fewer loans and the money supply is reduced.
2. Sell government securities. People buy government securities such as savings bonds from the Fed as an investment. The money people pay for the government securities is transferred from the public to the Fed, reducing the money supply.
3. Raise the discount rate. Because the discount rate is higher, banks borrow less money from the Fed. With less money to lend, banks cut back on loans and the money supply is reduced.
To increase the money supply, the Fed can...
1. Lower the reserve requirement. With more dollars available to lend, banks make more loans and the money supply is increased.
2. Buy government securities. The Fed buys government securities from people. The money the Fed pays for the government securities is transferred from the Fed to the public, increasing the money supply.
3. Lower the discount rate. Because the discount rate is lower, banks borrow more money from the Fed. With more money to lend, banks make more loans and the money supply is increased.
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Figure 2.1

Library of Congress

The theories of British economist John Maynard Keynes have shaped U.S. economic policy in the twentieth century. Keynes advocated that government use its taxing and spending powers to keep the nation's economy growing steadily.

money. Lowering the discount rate encourages banks to borrow money from the Fed. This injects more money into the economy because banks have more money to lend. Conversely, raising the discount rate discourages banks from borrowing money from the Fed. Banks will then have less money to lend to consumers and businesses, and less money will be pumped into the economy.

Open Market Operations. The tool the Fed most often uses to affect the money supply is *open market operations*. Open market operations are the purchase or sale by the Fed of *U.S. government securities*—IOUs such as U.S. savings bonds, treasury bills, and treasury notes. When the Federal Reserve wants to pump money into the economy, it buys government IOUs from businesses. The money the Fed pays is deposited in the sellers' banks, giving banks more money to lend. On the other hand, by selling government IOUs to investors, the Fed removes money from the economy. With less money in circulation, consumers spend less, resulting in businesses laying off workers and delaying purchases of new equipment. This decrease in consumer spending and business investment causes the economy to slow, thus lowering inflation.

Which Monetary Policy?

Monetary policy is designed to fight either inflation or unemployment—it cannot reduce unemployment and decrease inflation at the same time. An *easy money policy*, in which the Federal Reserve increases the money supply, may reduce unemployment, but inflation will rise. Higher spending by businesses and consumers causes businesses to hire more workers to meet the increased demand. However, when spending increases faster than businesses can supply the products in demand, prices rise, fueling inflation.

On the other hand, a *tight money policy*, in which the Fed decreases the money supply, may lower inflation but will increase unemployment. When the money supply decreases, people have less money to spend. This keeps prices from being pulled up by high demand. However, business sales fall and some companies may be forced to lay off workers. For the most part, the Federal Reserve attempts to strike a balance between an easy money policy and a tight money policy. It will favor first one policy, then the other, in an effort to maintain overall economic stability.

Fiscal Policy

The federal government also attempts to promote steady economic growth, full employment, and stable prices through fiscal policy. Fiscal policy is the use of the federal government's taxing and spending powers to influence the economy. Congress and the president develop the nation's fiscal policy.

Since the 1930s, the federal government has used fiscal policy to influence the demand for goods and services in the economy. Many economists agree with the theories of British economist John Maynard Keynes. According to

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Keynes, recessions occur because spending is too low. To get the economy moving again, the government must increase its own spending or the spending of businesses and consumers. Keynes also believed that too much spending in the economy causes inflation. Thus, to fight inflation, the federal government needs to reduce its own spending or the spending of businesses and consumers.

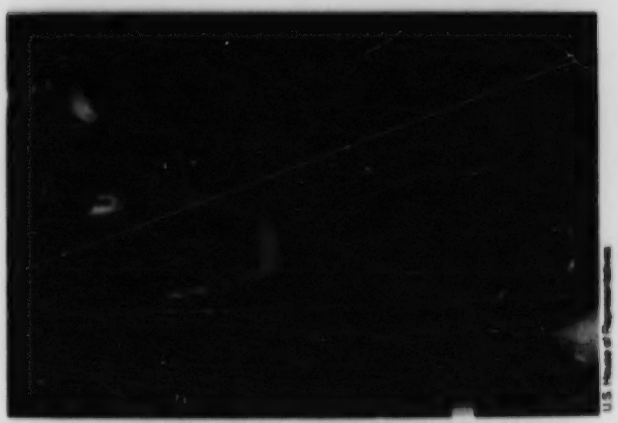
Tools of Fiscal Policy

Congress and the president use two tools to carry out fiscal policy: taxes and spending. Lawmakers can raise or lower taxes to affect the spending of businesses and consumers. How much money the government collects in taxes determines how much money people have left to spend. The government can also affect the economy by changing government spending.

Taxes. The federal government collects taxes from people to pay for the many goods and services it provides, such as national defense and social programs. In addition, the federal government uses its tax policy to moderate the ups and downs of the economy. For example, Congress and the president can reduce inflation by raising federal taxes. To pay the higher taxes, people must cut back on other spending. Consumers buy fewer CD players, hamburgers, and manicures. Consequently, businesses postpone opening new factories and buying new machines. Lower consumer spending and business investment cause the economy to slow, thus lowering inflation.

Conversely, Washington policymakers can fight unemployment by lowering federal taxes. A tax cut puts more money in people's pockets, allowing them to buy more goods and services. Businesses invest in new equipment and hire more workers to meet the growing demand. Greater consumer spending and business investment stimulate the economy and create more jobs.

Spending. The amount of money the federal government spends also has a significant impact on the nation's economy. Increased government spending can create jobs and increase profits. But a cutback in federal spending can have the opposite effect. Congress and the president can stabilize the economy by changing the federal government's spending. For instance, policymakers can fight inflation by decreasing government spending. Thus, the government buys fewer goods and services and/or pays out less money in transfer payments such as veterans' benefits. Such a cutback in federal spending decreases demand for goods and services, and business activity slows.



Congress, in consultation with the president, determines the nation's fiscal policy. But with 535 members, Congress cannot respond as quickly to economic problems as the Federal Reserve Board of Governors.

On the other hand, Congress and the president can put more Americans to work by increasing federal spending. The government purchases more products or gives out more money in transfer payments, causing demand for goods and services to rise. Therefore, businesses respond to the higher demand by hiring more workers.

Which Fiscal Policy?

Fiscal policy, like monetary policy, is designed to fight either inflation or unemployment but not both at the same time. An *expansionary fiscal policy*, in which the government cuts taxes

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and/or increases spending, may reduce unemployment but can cause inflation. If consumers, businesses, or the government increase purchases of goods and services, more workers are hired to meet the growing demand. But if spending goes up faster than the economy's production, prices will rise.

A *restrictive fiscal policy*, in which the federal government raises taxes and/or decreases spending, may reduce inflation but can cause unemployment to rise. When demand for products goes down, businesses lay off workers. However, decreased spending means there is less competition for products, and thus, inflation is reduced. Government officials must choose which economic problem—inflation or unemployment—they wish to target when making fiscal policy.

Because fiscal policy is set by elected officials, it is more vulnerable to political pressures than is monetary policy, which is made by appointed officials. The president and members of Congress, unlike the directors of the Federal Reserve, can be voted out of office if they make unpopular decisions. Higher taxes and reduced government spending tend to be unpopular with most Americans. Thus, elected officials often find it difficult to adopt a restrictive fiscal policy.

In addition, changes in fiscal policy are likely to be made more slowly and are more subject to compromise than changes in monetary policy. With only seven members, the Federal Reserve board can quickly decide on a monetary policy. But the president and the 535 members of Congress often disagree about what is the best fiscal policy. Reconciling these differences can take months or even years.

Trade Policy

Americans depend on the exchange of goods and services between nations. Without international trade, U.S. consumers would not have—or would pay much more for—such common items as coffee, bananas, televisions, and clothing. In addition, many American workers rely on world trade for jobs and incomes. For example, one out of eight U.S. manufacturing jobs is connected to selling goods overseas. Businesses count on other countries to buy American goods like grain and chemicals and to supply raw materials such as tin and oil.

Americans import many products, such as automobiles, food products, and electronic equipment.

When nations trade, their economies grow faster than if they try to be self-sufficient and make all the products their citizens want. Nations trade because they have different resources—such as fertile soil, skilled labor, or technical superiority—that enable them to produce some goods and services at lower cost than other countries can. International trade allows each nation to specialize in making the goods and services it produces most efficiently and then trade those products with other countries that are especially good at producing something else. In this way, trade increases a country's standard of living.

Tools of Trade Policy

Americans look to the federal government to further their interests in the international marketplace. Consumers want a wide variety of products at the lowest possible prices. Workers seek to protect their jobs and wages. Businesses want to increase profits. The federal government uses several tools to promote these different interests in the world market. Such tools include restricting *imports* (products that the United States buys from other nations), promoting *exports* (products that the United States sells to other nations), and working with nations to increase trade.

Restricting Imports. Many industries in the United States must compete with foreign manufacturers for sales and profits. Sometimes, this competition becomes so fierce that American companies ask the federal government to limit imports of foreign goods, thus reducing competition. The U.S. automobile industry provides a good example of a domestic business that would want to restrict imports.

For years, most Americans only bought American-made cars. Many people believed that American cars were the best in the world, and U.S. automakers such as General Motors, Ford, and Chrysler thrived. But as gasoline prices shot up in the 1970s, Americans began buying Japanese-made cars, which were smaller and more fuel-efficient than domestic cars. During the 1970s and 1980s, U.S. car manufacturers saw their share of the market fall while the fortunes of Japanese car manufacturers soared. Today, many U.S. automakers and autoworkers want the federal government to limit the number of Japanese cars imported to the United States so that Americans will buy fewer foreign cars and more domestic cars.

The government can restrict imports four ways. First, it can impose *protective tariffs*. Protective tariffs are taxes on imports designed to increase the sales of American-made goods by making imports more expensive. Such tariffs raise the price of foreign goods as high as, or higher than, similar domestic goods. Shoes and clothing are among the many goods subject to protective tariffs.

The government can also restrict imports by setting *import quotas*. Import quotas limit the amount of foreign goods that can be brought into the country. By reducing competition, import quotas help American companies sell their goods and allow both U.S. and foreign businesses to charge more for their products.

Another way the government can limit imports is through *voluntary trade restrictions*. These are agreements in which foreign businesses "voluntarily" restrict their exports to a particular country. Exporters usually sign such agreements to avoid protective tariffs or import quotas. For example, in 1981 Japanese car manufacturers agreed to limit their exports to the United States. This agreement encouraged the sale of American-made cars and allowed both U.S. and Japanese automakers to charge higher prices.

Finally, the federal government can adopt a variety of *nontariff barriers* to keep foreign goods out of the country. For example, the government can require foreign businesses to fill out long and complicated customs forms before allowing imports into the United States. Long delays in processing paperwork can discourage exporters. Similarly, federal officials can require imports to meet standards that are higher than those that U.S. manufacturers must meet. For example, lawmakers could require that each imported automobile be tested before it can be sold in the United States.

Promoting Exports. Many U.S. companies compete with foreign businesses in the international marketplace. But most foreign governments help their domestic industries. For instance, European nations give money to their farmers, enabling them to charge less for their produce than American farmers. The U.S. government may step in with aid to U.S. businesses to offset such foreign subsidies. By helping U.S. companies sell their products overseas, the federal government helps keep American workers employed. In turn, the federal government benefits from the extra taxes that U.S. workers and companies pay when business is thriving.

The U.S. government can promote exports in three ways. First, it can provide financial help to nations that want to buy American goods. For example, the United States may give money to a country with the understanding that a portion of the aid will be spent on American-made computers, tractors, airplanes, and the like. The government also offers nations low-cost loans to help foreign countries purchase American products. These loans, for instance, encourage Russia to purchase grain from American farmers.

USDA photo by Doug Wilson

The federal government promotes exports of U.S. grain through low-cost loans to foreign buyers.

The U.S. government can also promote exports by subsidizing American industries. For example, the government could give money to U.S. shoe manufacturers who have been losing sales to cheaper imports. Businesses would use the government money to pay wages or buy new machines. U.S. shoe companies could then charge less than their foreign competitors.

A third way the federal government promotes exports is by lowering the value of the dollar. To weaken the dollar, the Federal Reserve sells dollars in international currency markets. An increase in the supply of dollars in international markets causes the value of the dollar to fall. If the dollar is worth less compared to foreign currencies, U.S. exports are cheaper for foreign buyers. Foreign consumers react to these lower prices by buying more American-made products. For instance, if a pair of U.S.-made blue jeans costs 200 French francs, a French teenager might only be able to afford one pair. But if the price of the same pair of jeans falls to 100 francs because of the weaker U.S. dollar, the teenager may buy two pairs. Sales of U.S.-made blue jeans rise, and American jeans companies earn more money and can hire more workers.

Working with Other Nations. Since the 1930s, the United States has cooperated with other countries to increase world trade. For instance, the Reciprocal Trade Agreements Act of 1934 allowed the president to lower U.S. trade barriers with one country in return for the same favor.

The United States encourages international trade by providing a stable financial environment. For example, the U.S. government supported the creation of a new international monetary system at Bretton Woods, New Hampshire, in 1944. Under the Bretton Woods system, the values of foreign currencies were fixed in terms of the U.S. dollar. For example, the value of the British pound was set at $2.80. This system of *fixed exchange rates* continued until 1971. Since then, the values of currencies have been determined by buyers and sellers on the open market. This is called a system of *floating exchange rates*.

The United States also promotes international trade by participating in the General Agreement on Tariffs and Trade (GATT). Created in 1947, GATT is both a treaty and an organization with about 100 members. GATT sponsors negotiations to liberalize international trade. In 1993, GATT members approved a sweeping agreement to eliminate trade barriers around the world.

Finally, the U.S. government works with individual nations to increase trade and provide a stable economy at home. For example, in 1992 the United States, Canada, and Mexico signed the North American Free Trade Agreement (NAFTA). NAFTA, which took effect in January 1994, will gradually eliminate all trade barriers between the three countries, creating the largest regional free-trade zone in the world.

Which Trade Policy?

In developing the nation's trade policy, Congress and the president must consider the competing interests of consumers, workers, and businesses (figure 2.2). Most

economists believe that Americans generally benefit from a policy of *free trade*, in which nations exchange products without restrictions. Consumers enjoy more goods and pay lower prices under free trade because foreign competition forces domestic industries to improve the quality and lower the prices of their products. Industries that use imported raw materials can make more money if trade is unrestricted because trade barriers will raise the cost of imports. Businesses that export benefit from greater access to foreign markets.

Effects of Protectionism
Protected U.S. industry may have
• more jobs
• higher profits
• less incentive to produce goods more efficiently because of decreased foreign competition
Other U.S. industries may have
• foreign trade barriers imposed on them in response to U.S. protectionist policies
• reduced sales overseas because other countries are selling fewer goods in the United States and have less
• higher unemployment
U.S. consumers may have
• higher prices
• fewer goods to choose from
• less money to buy other products
UNITED STATES

Figure 2.2

However, American industries and workers that compete with foreign companies may benefit from a policy of *protectionism*. The U.S. government does protect some defense-related industries—such as steel—from foreign competition. The United States does not want to be dependent on foreign countries to supply goods vital to U.S. national security. Also, federal lawmakers have a history of protecting the nation's "infant" industries until they have grown enough to compete against established foreign companies. High tariffs in the 1800s, for instance, helped the new U.S. textile industry survive. The U.S. government also erects trade barriers to help businesses recover from a slow period. For example, by the early 1980s, the Harley-Davidson motorcycle company was near bankruptcy, but a stiff tariff on Japanese imports from 1983 to 1986 gave the company time to get back on its feet.

Federal policymakers often respond to the pleas of workers and businesses for protection. Americans who would benefit from trade restrictions tend to be politically active, because they have a large stake—namely jobs and higher profits—in the adoption of trade barriers. In addition, most people tend to accept trade barriers because the costs of protectionism borne by each citizen are usually quite small and are hidden in the prices of imported goods.

Monetary, Fiscal, and Trade Policies: Powerful but Imperfect Tools

Effective monetary, fiscal, and trade policies can keep a healthy economy strong. They can also be used to revive an ailing economy. However, for a policy remedy to be effective, the right dose must be administered at the right time. Several factors complicate government efforts to manage the economy.

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WE'VE GOT TO KEEP THOSE BLASTED FOREIGN IMPORTS OUT OF THE COUNTRY!
PROTECTIONISM WILL JUST TRIGGER RETALIATION BY OTHER COUNTRIES...
AND ALL YOU'LL END UP DOING IS MAKING MORE UNEMPLOYMENT
BUT IT'LL BE MADE IN AMERICA!

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- **Forecasting problems.** Government officials use economic forecasts in developing monetary, fiscal, and trade policies. But correctly predicting the economy's future is difficult. Collecting and studying the many statistics needed to forecast business trends takes months. The economy often sends unclear or contradictory signals. And experts may interpret the same economic data differently. As a result, inaccurate economic forecasts can lead to inappropriate policies.

- **Timing problems.** Inevitable delays in making and implementing policies complicate the government's efforts to manage the economy. Once policymakers recognize a change in the economy, they need time to decide on the appropriate action. Government officials cannot make major decisions hastily. After a policy change is made, more time must pass before the impact is fully felt throughout the economy. By that time, the economy may be experiencing a different problem than the one the policy was designed to correct.

- **Coordination problems.** Policymakers sometimes work against each other in trying to achieve economic goals. Federal officials may not target the same economic problem. In the early 1980s, for example, the government's monetary and fiscal policies contradicted one another. The Federal Reserve, seeing inflation as the nation's number one problem, tightened the money supply. Congress and the president, in contrast, cut taxes in an effort to reduce unemployment. The conflict between these two policies made it difficult to stabilize the economy.

  In addition, state and local governments may counteract the efforts of the national government. During a recession, for instance, the economy benefits from increased government spending. But at the same time, tax collections decline because fewer people are working and business profits have fallen. As a result, state and local governments generally cut spending in an effort to balance their budgets.

- **Unpredictable economic behaviors.** Government actions are only one element of the economic equation in the United States. Individual Americans make thousands of decisions every day that shape the economy. However, their actions are often unpredictable. Consumers, workers, and businesses can take independent actions that contradict the effects of government policies. For example, the Federal Reserve may tighten the money supply in an attempt to reduce inflation. But labor unions may have long-term contracts that guarantee automatic salary increases—which are inflationary.

  The government's efforts to keep the economy healthy are also complicated by international events. For example, in 1990, Iraq invaded the oil-rich nation of Kuwait. In response, most nations put an embargo on oil shipments from Iraq and Kuwait. With less oil available, energy costs rose. Thus, the policies of other nations have a tremendous impact on the United States.

Because of the complexity of using economic tools, Americans disagree about whether their government should

try to manage the economy. Some people believe that the economy would be relatively stable if left alone. They argue that government efforts to steer a course between inflation and unemployment do more harm than good. Others think that the government should use its policy tools to smooth out the extremes of the business cycle. These Americans believe that the federal government has a duty to act, because of the human misery caused by unemployment and inflation.

Economics is an inexact science. It is almost impossible to develop policies that consistently solve the nation's complex economic problems. Government officials have no guaranteed formulas for applying monetary, fiscal, and trade policies to produce desired results.

3

The Federal Budget and the Economy

Money . . . sustains [government's] life and motion and enables it to perform its most essential functions.
Alexander Hamilton—First U.S. Secretary of the Treasury

Americans expect many services from their government. For example, they expect the government to give aid to the needy, defend the nation, build highways, maintain parks, educate children, clean up the environment, punish criminals, find cures for diseases, and eliminate drug abuse. However, these government services cost large sums of money. Given unlimited resources, the government could fulfill everyone's desires. But because funds are limited, leaders are forced to make choices. Lawmakers must decide who to tax and at what rate, how much to spend and for what purposes, and how big a gap—if any—to allow between federal spending and income.

The taxing and spending decisions of U.S. leaders are reflected in the *federal budget*. The federal budget is the U.S. government's plan for raising and spending money during its *fiscal year*—a twelve-month accounting period beginning October 1 and ending September 30. However, the federal budget is more than a financial statement. It is also a statement of values, identifying the social, economic, and political priorities of the nation.

The federal budget profoundly affects the economy. Government taxing and spending influence how many jobs are available, how fast prices rise, and whether the economy grows. Ultimately, the budget decisions of federal policymakers go far in determining the nation's economic future.

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1. Spring
Office of Management and Budget (OMB) assigns government agencies a maximum amount for their budget proposals.
2. Summer-Fall
Agencies submit their proposed budgets to OMB. Agency directors meet with OMB executives and the president's staff to justify proposed spending and to finalize the budget.
3. January
The president submits budget proposal to Congress.
4. February
Congressional committees submit program estimates to budget committees.
5. April
Budget committees report the first budget resolution. The resolution sets targets for government spending by Congress.
6. May
Committees report authorization bills; Congress completes action on first budget resolution. Neither house may consider authorization or spending bills nor changes in tax revenues or the national debt until the first budget resolution is adopted.
7. May-August
Congress completes action on all budget and spending bills.
8. September
Congress completes action on a reconciliation bill to bring the budget in line with spending bills. Congress may not adjourn until it completes action on these measures.
9. October 1
Fiscal year begins.

Figure 3.1

This chapter examines how national leaders choose among many competing priorities when making the federal budget. It also looks at how the federal government raises and spends money.

Making the Federal Budget

In 1789, President George Washington jotted down the nation's first budget on one piece of paper. Today, that same document is larger than the Manhattan telephone directory, consisting of more than 1,000 pages of small type and hundreds of tables.

Thousands of people work year round to develop the federal budget. From start to finish, the process takes about eighteen months (figure 3.1). Thus, before one year's budget is completed, work on the next one begins. For example, while Congress is hammering out a budget for fiscal year 1996 (which runs from October 1, 1995, to September 30, 1996), the executive branch is drafting a budget proposal for fiscal year 1997.

The executive and legislative branches share responsibility for developing the budget. Under the direction of the president, the executive branch draws up a proposed budget to send to Congress. Then the House of Representatives and Senate create their own version of the budget, which may differ significantly from the president's budget.

Executive Branch Budget Process

Until 1921, presidents had little to say about the federal budget. Federal agencies usually sent their budget requests directly to Congress. However, the Budget and Accounting Act of 1921 changed this procedure. The law now requires the president to propose a budget to Congress by the first Monday in February for the upcoming fiscal year.

The president delegates the responsibility of drawing up a budget proposal to the Office of Management and Budget (OMB). The director of OMB reports directly to the president. The president relies on the OMB to track government

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income and spending and to prepare a budget based on the administration's priorities.

Work on the federal budget begins about a year and a half before it goes into effect. The first step in preparing the president's budget is for federal agencies—such as the Department of State and the Bureau of Indian Affairs—to draw up budget requests. Agencies often overestimate their needs, knowing that OMB or Congress will probably cut their budget requests. Each agency tries to show through public hearings and written reports that its programs are effective and efficient. *Interest groups* (groups of Americans organized to influence government decisions) and political party leaders also pressure the president to expand or preserve their favorite programs.

After reviewing each agency's request, the OMB director develops a final budget proposal. Once the president approves it, this document is printed and submitted to Congress. Adopting the federal budget then becomes the responsibility of the House and Senate.

Congressional Budget Process

The role of Congress in the budget process is crucial. According to the U.S. Constitution, only Congress has the power to raise money for the federal government. Congress is also responsible for spending government funds. No federal program can operate without receiving approval and funding from Congress. Congress grants approval by passing an *authorization bill*, which states the goals of a program and the amount of money that can be spent on the program. Congress actually provides money for a program by passing a separate *appropriation bill*. All authorization and appropriation bills must pass both houses of Congress and be approved by the president.

After receiving the president's budget proposal, House and Senate Budget committees, with help from the *Congressional Budget Office*, analyze it. The two budget committees then propose a first budget resolution. This resolution sets targets for taxes and ceilings on broad categories of spending, such as health and defense. By law, Congress must adopt the first budget resolution by April 15.

From May to September, various committees and subcommittees consider specific tax and spending bills. For example, the Senate Armed Services Committee drafts bills dealing with defense spending. The first budget resolution guides the taxing and spending decisions of individual committees in Congress.

By September 15, spending bills are passed by both houses of Congress and signed by the president. Both the House and Senate then adopt a second budget resolution, which establishes final tax targets and limits on spending. These targets may be different from the first resolution. Passage of this second resolution marks the end of the budget-making process. On October 1, the start of the fiscal year, federal agencies can begin spending the money appropriated for them by Congress.

These steps describe how the congressional budget process is supposed to work according to law. In practice, Congress usually misses one or more of the deadlines. Sometimes spending bills are not passed before the new fiscal year begins. Without these spending bills, the government has no money to operate. Therefore, to avoid shutting down the government, Congress usually passes an emergency spending bill.

Making the budget is difficult because members of Congress must contend with intense pressures from many groups, including the president, federal agencies, interest groups, and their constituents. Policymakers must also consider the needs of the nation as a whole.

The President. Because Congress and the president often disagree about priorities, the president tries to rally support for the administration's version of the budget. Presidents often telephone members of Congress to ask for their support. Presidents can also use more subtle means to win votes, such as inviting members of Congress to meetings and special White House dinners. As one former member of Congress said, "When the attention of the most important person in the free world is focused on you, even for a short while, it can weaken one's defenses."

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Federal Agencies. Every federal agency fights hard to retain and increase its share of budget dollars. Agencies present their cases to the Office of Management and Budget and Congress through public hearings and written reports. Sometimes ploys such as "the Washington Monument game" are most effective. For example, when Congress threatens to cut the budget of the National Park Service, the Service announces that cutbacks may force the closing of a popular tourist site, such as the Washington Monument. To avoid such an unpopular result, Congress will probably restore the Park Service's funds. Other agencies have their own variations of this tactic.

Interest Groups. Americans with a common interest often organize to give themselves a political voice. Interest groups are heavily involved in the federal budget process, lobbying (attempting to influence) members of Congress on a wide range of issues.

Many interest groups seek to preserve and expand their favorite spending programs. For example, the American Association of Retired Persons (AARP) fights to increase Social Security and Medicare benefits. Similarly, the American Israel Public Affairs Committee (AIPAC) works to raise U.S. aid to Israel.

Other groups take positions on taxes. Some lobby for special tax breaks. For example, museum directors seek tax laws that encourage collectors to donate art work to museums. Others fight higher taxes on their products, which would reduce their sales. The U.S. Brewers' Association, for instance, opposes higher taxes on beer.

Most experts agree that congressional budget decisions are influenced by interest groups. One reason is the high cost of congressional campaigns. Lawmakers who choose to run for reelection—and most do—want enough money to fight off challengers. Interest groups can reward members of Congress with campaign contributions, blocs of voters, and favorable advertisements. On the other hand, lawmakers who vote against an interest group's cause may find themselves targeted for defeat by that group.

Constituents. In considering the budget, lawmakers must also attend to the interests of their districts or states—the voters back home. For example, a representative from New England, which has cold winters, is under strong pressure from voters to oppose taxes on home heating oil. Similarly, a senator from the Corn Belt must fight for more aid to farmers—or face defeat in November.

Sometimes, the needs of the nation conflict with the needs of a lawmaker's district or state. For instance, many experts have proposed closing some military bases around the country in an effort to cut federal spending. But military bases mean jobs and prosperity to local communities. Thus, members of Congress find it difficult to cut programs that benefit their districts—even though such cuts would save taxpayers money.

Throughout the budget process, members of Congress are buffeted by different interests. Lawmakers must consider the views of the president, federal agencies, interest groups, constituents, and the needs of the nation as a whole. Much of the pressure that lawmakers face has to do with how federal money is going to be spent. But a great deal of the pressure also relates to how that government money is going to be raised.

Raising Money

The federal budget determines how the U.S. government will pay for its programs (figure 3.2). In fiscal year 1995, the government in Washington, D.C., took in more than $1.3 trillion. Where does all this money come from? A small fraction of federal funds comes from sources such as court fines, charges for postage stamps, and fees for passports. However, the federal government gets most of its *revenue*, or income, from *taxes*. Taxes are payments of money that individuals and businesses must make to the government.

Taxes

The U.S. government levies, or imposes, many different kinds of taxes. The biggest source of revenue is the *individual income tax*—a tax on a person's yearly earnings. An individual's income might include wages, tips, and interest from bank accounts. In most cases, employers deduct income taxes from workers' paychecks and forward the money to the Internal Revenue Service (IRS)—the branch of the U.S. Treasury Department that collects taxes. By April 15 of each year, Americans must file *tax returns* with the IRS for the preceding calendar year. A tax return lists a person's income and any taxes owed to the government or refunds due to the taxpayer.

The federal individual income tax is a *progressive tax* because it takes a larger percentage of higher incomes than lower incomes. In 1993, for example, a single attorney with a taxable income of $50,000 would have paid 22 percent of his or her income in taxes, whereas an unmarried typist with a taxable income of $10,000 would have paid 15 percent of his or her income in taxes. The idea of a progressive tax is that wealthy people, who can better afford it, should carry more of the tax burden than can people with low incomes.

Social Security taxes are the second largest source of federal revenue. These taxes finance health care for older Americans and payments to retired and disabled people. After these payments are made, any money that remains is loaned to the federal government so it can pay its other bills.

Figure 3.2

Because Social Security taxes are typically deducted from workers' paychecks and matched by employers, they are often called "payroll taxes." Social Security taxes show up on a worker's paycheck stub as a deduction for FICA—Federal Insurance Contribution Act—the law that sets out the procedure for paying Social Security taxes.

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Co. Code	Department	File No.	Check/ID	Social Security No.	Name	Pay Period	Pay Date
642	033	17765		508-46-3531		ENDING 02/16/94	2/22/94

Hours/Units	Rate	Earnings	Type	Deduction	Type	Deduction	Type
8000	113077	113077	REG	5654	403-B	76128	CHECK1

	Gross Pay	Federal Income Tax	Soc. Sec. Tax	Medicare Tax	State Income Tax	Local Income Tax	SUI/SDI	Net Pay
This Pay	113077	15325	7011	1639	7320			
YTD	482308	61300	28043	6558	29280			

Close Up Foundation

Federal income and Social Security taxes are withheld from the paychecks of workers.

At first glance, Social Security taxes appear to be *proportional taxes*—taxes that take the same portion of everyone's income—because workers pay the same percentage of their wages up to a maximum amount. But in fact, Social Security taxes are *regressive taxes*. That is, they take a larger share of low incomes than high incomes. Social Security taxes are regressive because workers pay Social Security tax up to the yearly maximum. Any income above that maximum is not subject to Social Security taxes. In 1993, for instance, workers paid 7.65 percent of the first $51,300 of their wages. So in 1993, a lawyer with a salary of $75,000 paid $3,924.45, or 5.23 percent of her salary, in Social Security taxes. At the same time, a bricklayer whose wages came to $20,000 paid $1,530, or 7.65 percent of his wages, in Social Security taxes. Social Security taxes are also regressive because they are only levied on wages and not on other types of income (such as rent and interest) that wealthier people are more likely to earn.

The third largest share of federal revenue comes from *corporate income taxes*. Corporations, like individuals, pay taxes on profits. But in contrast to individuals, corporations can pass on part of the cost of taxes to consumers in the form of higher prices. Corporations can also shift part of the tax burden to their employees in the form of lower wages and to the companies' owners (or *stockholders*), who receive smaller *dividends*, or shares of the corporation's profits.

A small percentage of federal revenue comes from *excise taxes* that are laid on the manufacture, sale, or use of certain products within the United States. For example, the federal government imposes excise taxes on cigarettes, beer, and telephone service. Most excise taxes are included in the prices of items that consumers buy. Often, people are unaware that they are paying excise taxes. For this reason, excise taxes are sometimes called "hidden taxes." Excise taxes on necessities like gasoline are regressive taxes because people with low incomes must spend a higher percentage of their incomes on essentials like food, clothing, and transportation than the rich. But excise taxes on luxury items such as fur coats are progressive taxes because low-income people cannot afford to buy them.

Estate and gift taxes, which were established to keep wealth from being concentrated in the hands of a few families, account for a small share of federal funds. An *estate tax* is a tax on the money and property of someone who has died. A tax on the transfer of money or property between living persons is called a *gift tax*. Gift taxes were enacted so that people could not avoid estate taxes by giving away their money and property before death. Estate and gift taxes are progressive taxes because the taxes apply only to valuable estates and large gifts and, therefore, usually affect only the rich.

A tiny portion of national revenue comes from taxes on goods brought into the United States from other countries. Such taxes are called customs duties, or tariffs. Before the adoption of the income tax in 1913, *customs duties* provided most of the national government's revenue. Businesses pay

customs duties when they import goods. But consumers ultimately bear the cost of tariffs because businesses raise the prices of imports to cover the amount of the tax. Customs duties are regressive taxes because people with lower incomes spend a larger share of their incomes than wealthier people.

Borrowing

The federal government rarely has a *balanced budget*, where it takes in as much money as it spends, or a *budget surplus*, where it collects more money than it spends. Usually, the government has a *budget deficit*, where it spends more money than it takes in. Therefore, it borrows money to make up the difference. Government borrowing adds to the *national debt*, which is the total amount of money the federal government owes from past borrowing. In 1994, the national debt totaled almost $4.5 trillion.

The government borrows money by selling securities such as savings bonds to individuals, businesses, and other organizations. People who buy U.S. government securities receive at a later date the amount of the loan plus interest. For instance, a person who buys a $50 U.S. savings bond today for $25 will receive $50 twelve years later when the bond reaches maturity.

The U.S. government borrows most of its money from Americans. However, the government also depends on foreign investors to finance budget deficits. Almost 20 percent of the money the U.S. government has borrowed to finance its debts is owed to foreign investors. Many investors—both foreign and domestic—purchase U.S. government securities because they seem to be a safe investment. Most people believe that the U.S. government will pay back the money it borrows.

Spending Money

The federal budget also shows how the government plans to spend the money it raises (figure 3.3). In 1994, the federal government spent more than $1.5 trillion. Where does this money go? The largest share of federal spending goes for direct benefit payments to individuals. Every month, the U.S. Treasury mails checks to millions of retired, disabled, and low-income Americans.

Cross Up Foundation/Fairies Bouchard

Drivers pay a federal excise tax on every gallon of gasoline they buy. Money collected from gasoline taxes is used to maintain and improve U.S. highways.

Spending for these benefits as a share of the federal budget has increased dramatically since 1960. One reason such spending has jumped is that since 1972, benefit payments such as Social Security have been automatically increased at the same rate as inflation so that people do not lose purchasing power. Another reason is that the number of Americans eligible for benefits is increasing every year. As the percentage of Americans over the age of 65 increases, government payments for Social Security rise.

Figure 3.3

National defense takes the second biggest share of the federal budget. This category includes purchases of equipment and supplies, salaries for members of the armed forces, operation of military bases, and research on weapons. However, the U.S. defense budget has been scaled back in recent years. The 1993 deficit reduction package passed by Congress is designed to reduce defense spending by more than $120 billion by 1998.

Interest payments on the national debt are the third largest—and fastest growing—federal expenditure. Like any borrower, the government must pay interest on the money it owes. The more money the government borrows, the more interest it must pay. Higher interest payments reduce the amount of money available for other programs. For example, the interest paid on the national debt in fiscal 1995 would have paid for the deficit as well as many federal programs.

Some federal funds flow directly to cities, counties, and states. Federal dollars pay for a variety of programs, including mass transit, highway construction, education, and law enforcement. During the 1980s, federal aid to state and local governments declined.

The smallest share of federal spending—called domestic discretionary spending—goes for such programs as law enforcement, medical research, space exploration, and environmental protection. During the 1980s, this category of federal spending was cut the most.

In developing the federal budget, Congress and the president must make many hard choices. How much money should the federal government spend? What programs should be funded? Who should pay how much in taxes? These are just some of the decisions that policymakers face.

Budget decisions have a significant impact on the nation's economy. Government taxing and spending can create or eliminate jobs, keep prices stable or stimulate inflation, and help the economy grow or stifle its growth. Thus, the choices made by U.S. officials as reflected in the federal budget influence how America's economic future will look.

4

Today's Choices, Tomorrow's Legacies

We face a future of economic choices that are far less pleasant than any set of choices we have confronted in living memory.
Peter G. Peterson—Former U.S. Secretary of Commerce

In 1941, *Life* magazine christened the twentieth century the "American century." Even before World War II, the United States was a leading economic power, producing more than Germany and Japan combined. By the end of the war, most of the industrial nations were in ruins, and the United States was manufacturing 40 percent of the world's goods. The U.S. dollar became the world's most important currency. The strong U.S. economy provided Americans with the world's highest standard of living. Its economic clout allowed the United States to become a leading force in world affairs. To many people, the United States seemed destined to dominate global economics and politics for centuries to come.

For thirty years, the United States remained the world's strongest economic power. But during the 1970s, other nations began to challenge America's lead. Western European nations and Japan began manufacturing high quality, inexpensive goods that U.S. and foreign consumers wanted. The United States began importing more goods than it exported, and the country found itself running *trade deficits* for the first time in decades.

The U.S. position in the global economy continued to decline in the 1980s as the nation piled up large budget and trade deficits. To pay for government services and imports, Americans borrowed foreign money. As a result of this borrowing, the United States changed from the world's largest

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Figure 4.1

creditor (lender) nation to its largest debtor (borrower) nation. By 1994, Americans owed more than $600 billion to foreigners.

As the twentieth century comes to an end, some experts argue that the American century is over. They think that the United States will be sharing economic and political power from now on. By the same token, most analysts also believe that the United States can stay on top economically if it reduces its budget and trade deficits. What role will the nation play in the world of the future? The choices Americans make today will determine whether their country meets the challenges of the twenty-first century.

Federal Budget Deficits

Most Americans try to spend no more than they earn. But when faced with emergency expenses, people often have to borrow money. For many years, the same was true of the federal government. The nation went into debt to pay for wars. But in peacetime, the government would run budget surpluses and repay much of the money it had borrowed.

However, beginning with the Great Depression of the 1930s, the federal government began to run budget deficits for another reason—to revive an ailing economy. According to economic theory, the nation would climb out of debt once the economy recovered. In practice, this did not happen. Instead, the federal government has run budget deficits almost every year since 1930 (figure 4.1).

How Do Budget Deficits Affect the Economy?

Although federal budget deficits have become commonplace, during the 1980s many Americans began to worry as the gap between federal spending and revenue widened. In 1981, the national debt totaled $1 trillion, about $4,000 per citizen. By 1994, the national debt had climbed to $4.5 trillion—almost $14,000 per citizen. Many Americans believe that paying off this debt is rapidly becoming realistically impossible.

Many economists are also concerned because they believe that government borrowing has several important effects on the economy. Federal budget deficits

1. limit the use of fiscal policy to revive an ailing economy;
2. dampen economic growth;
3. force dependence on foreign money; and
4. affect America's future.

Budget Deficits Limit the Use of Fiscal Policy. During recessions, Congress and the president have tried to stimulate the economy by cutting taxes and/or increasing federal spending. However, many economists are worried that large budget deficits are limiting the use of fiscal policy. Tax cuts and higher government spending increase the deficit and the national debt. Plus, the deficit automatically rises when the economy is weak because workers lose their jobs and businesses earn less money. As a result, tax receipts fall, and welfare payments such as unemployment compensation rise. Thus, government officials are reluctant to use fiscal policy to stimulate the economy for fear of making the debt problem worse.

Budget Deficits Dampen Economic Growth. Many analysts also fear that large budget deficits are dampening economic growth. When the government spends more than

it takes in, it must make up the difference by borrowing money that people have saved. But there is not much money available for borrowing because Americans are poor savers. They save less than 5 percent of their after-tax incomes—less than citizens in other industrialized nations. Japanese citizens, for example, save about 14 percent of their after-tax incomes.

Thus, budget deficits force the federal government to compete with consumers and businesses for the limited supply of loanable funds. This increased demand for money drives up interest rates. Because loans cost more, consumers buy fewer goods and services. Reduced consumer spending means that some present-day workers are laid off or take pay cuts. More importantly, higher interest rates keep businesses from borrowing money to expand and modernize their operations. As a result, fewer new jobs are created.

Budget Deficits Force Dependence on Foreign Money. Analysts are also concerned about budget deficits, because to finance them the U.S. government is borrowing billions of dollars from foreign investors. During the 1980s, such heavy borrowing transformed the United States from the world's biggest lender to the world's biggest borrower. For the first time since World War I; the United States is in debt to the rest of the world. The federal government must borrow from abroad because the U.S. savings rate declined sharply during the 1980s, and there simply was not enough money available in the United States. So by 1994, 20 percent of the national debt was held by foreign investors. In contrast, just 5 percent of the national debt was foreign-owned in 1960.

When the national debt is owned by Americans, citizens who hold government IOUs receive interest payments on the debt as income. Thus, money is simply transferred from some Americans to others. But when the debt is owned by foreign investors, interest paid on that part of the national debt leaves the country. The dollars sent abroad to pay interest on the national debt are not available for business and government to invest on items such as education, modern equipment, and factories that make the U.S. economy more productive. Because Americans invest less money today, many experts believe the standard of living for future generations will be lower.

Budget Deficits Affect America's Future. Some analysts are concerned about what the borrowed dollars are being used for. Just as there is a difference between borrowing money to buy a house and borrowing money to go on vacation, there is a difference between various types of government spending. Some government spending makes the country more productive. In other words, if the government borrows money to build highways, educate children, or fund research for new technology, it is investing in the future. But most experts believe that money borrowed in the 1980s was not invested in ways that will benefit future generations. Instead, the federal government borrowed money to pay interest on the national debt. Many argue that because the United States did not invest in its economy during the 1980s, Americans will be less well-off in the future.

What Causes Budget Deficits?

Why does the federal government have such huge deficits? Many policymakers blame the Republican-controlled Reagan administration for the deficit. They point to the Reagan tax cut of the early 1980s—the largest tax cut in U.S. history. Critics of the tax cut claim that there were bound to be large budget deficits because of decreased revenues combined with President Reagan's call for increased defense spending.

In contrast, others believe that Democrats are responsible for federal budget deficits. These critics note that persistent budget deficits began under President Roosevelt way back in the 1930s and worsened under President Johnson. They also point out that Democrats have controlled both houses of Congress for most of the past sixty years, and that federal budget deficits are the result of heavy spending on social programs passed by those Democrat-controlled Congresses.

However, many experts believe that budget deficits exist because Americans want more government spending than they are willing to pay for. According to these experts, federal officials are merely responding to the will of the people—

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This highway was built with federal funds. Government spending on such projects helps increase the output of the U.S. economy.

as is to be expected in a democracy like the United States. In public opinion polls, Americans consistently say that taxes are too high. But these same people say that more money should be spent on particular programs, such as Social Security and AIDS research.

Federal lawmakers are caught between the contradictory demands of voters who want lower taxes but continued government spending. Members of Congress who vote against funding popular programs risk defeat at the polls. And members who support tax increases must face angry voters. Thus, *deficit spending* (spending more money than the government takes in) provides Congress and the president with a solution to this dilemma. Borrowing money allows the government to provide the services that voters demand, without raising taxes.

What Can Be Done about Federal Budget Deficits?

Many Americans are worried about federal budget deficits and feel they should be reduced. How can deficits be reduced? Experts generally agree that deficits cannot be eliminated simply by economic growth. If this is true, then reducing the deficit means cutting federal spending, raising federal taxes, or a combination of the two (figure 4.2). Another option for the government—and the nation—is to accept continued budget deficits and a rising national debt.

Cut Spending. Americans who favor a limited role for government think that the federal government should reduce the deficit by spending less. But cutting spending is difficult. Members of Congress are under constant pressure from their constituents and interest groups to spend money on specific programs.

Another reason it is difficult to cut spending is that about three-fourths of the budget consists of "uncontrollable" items—expenditures the government is legally required to make. However, these uncontrollable items can be controlled by changing the law.

Most of the uncontrollable spending goes for *entitlements*, such as Social Security and Medicare. Entitlement programs legally guarantee benefit payments to anyone who meets certain requirements. For example, every American aged 65 or older is "entitled" to Social Security and Medicare benefits. Because more than 60 million Americans receive payments from such programs, entitlements are difficult to reduce. Any talk of cuts brings loud protests from the people who get these benefits.

The rest of the uncontrollable spending goes for interest payments on the national debt and items such as fighter planes and dams that the federal government ordered in previous years. Interest payments cannot be cut without jeopardizing the nation's credit-worthiness. And breaking contracts means wasting the money spent in previous years.

Because 75 percent of the budget is uncontrollable, policymakers seeking to reduce government spending have searched for cuts in the remaining 25 percent of the budget. That portion of the budget includes funding for items such as environmental cleanup, education, health, transportation, public works, science, and law enforcement. But there is only so much that can be cut from this 25 percent. Thus, most experts agree that the deficit can only be reduced by cutting the 75 percent of the budget that is used mostly for entitlements.

How Uncle Sam Can Meet His Expenses

Borrow Money

Advantages

- Government services and programs can continue.
- Government retains political support from those helped by federal programs.
- Money is pumped into the economy, which stimulates economic growth.

Consequences

- Interest rates may increase because the amount of money available for loans to businesses and consumers may be reduced.
- Industries that rely on credit sales, such as housing and autos, suffer because consumers cannot afford to make long-term purchases on credit.
- National debt increases.
- Value of the U.S. dollar (in relation to foreign currencies) may increase. Sales of U.S. goods in foreign countries may decline.

Increase Taxes

Advantages

- Level of government services continues or grows. Government retains political support from those helped by federal spending.
- Budget deficit may be reduced.
- Inflation may be brought under control because consumers have less money to spend.

Consequences

- Consumers and businesses have less money to spend or invest.
- Government may lose political support from those taxed.
- Economic growth may slow down because consumer demand decreases.

Spend Less

Advantages

- Budget deficit may be reduced.
- Private sector assumes responsibility for functions previously performed by government.
- Banks have more money available to lend to consumers and businesses.

Consequences

- Government services may be cut back.
- Government may be less able to stimulate a slow economy through public spending.
- Reduced government services may lead to a decline in the standard of living for some members of society.
- Government may lose support from those helped by federal spending.

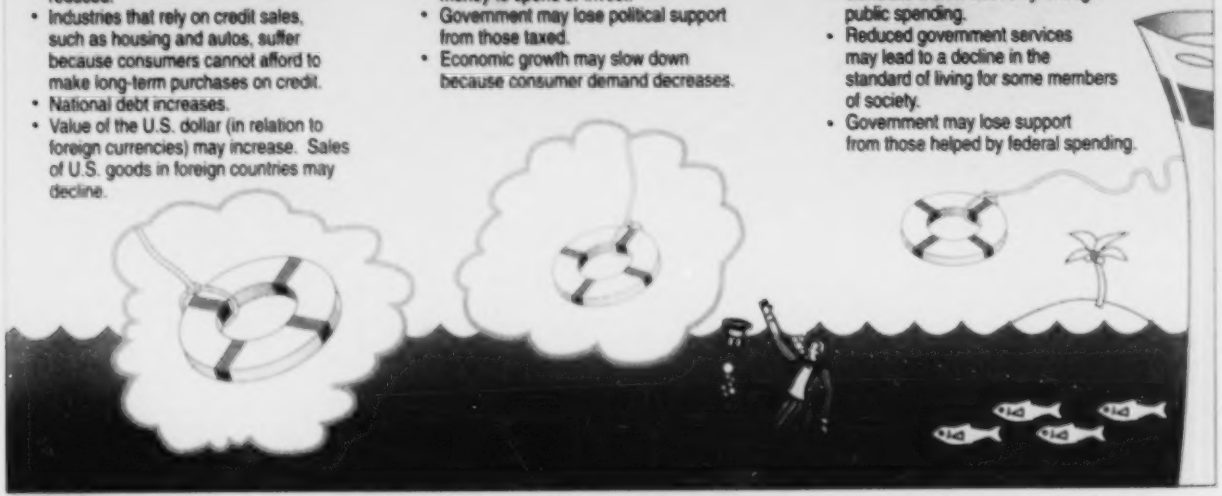

Figure 4.2

Raise Taxes. Other Americans think the federal government should maintain its role in the economy. They prefer to reduce the deficit by raising taxes rather than by cutting government programs. These citizens argue that Americans pay less in taxes than do citizens of other industrialized countries. But tax increases tend to be unpopular because most people think they already send too much money to Washington. In addition, many economists believe that high taxes discourage work and stifle economic growth.

Accept Deficits. Despite concern about budget deficits and the national debt, there has not been much public support for either lower spending or higher taxes. Some Americans are willing to accept budget deficits as a deterrent to greater government spending. These citizens believe tax increases would simply

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UPI/Bettmann

Retired Americans demonstrate against proposed reductions in Social Security benefits. Cutting federal spending is difficult because groups who benefit from government programs fight such cuts.

encourage higher government spending. Other Americans prefer budget deficits to cuts in government programs.

Some experts argue that Americans should not be concerned about the size of federal budget deficits and the national debt. They point out that, as a percentage of gross domestic product (GDP), federal budget deficits and the national debt were higher during the 1940s and 1950s than they are today. In addition, Japan and West Germany ran larger budget deficits as a percentage of GDP during the 1970s.

Analysts who are not worried about federal budget deficits and the national debt also note that the federal government, unlike individuals and businesses, cannot go bankrupt. Because it has the power to issue money and to tax, the government can always meet its interest payments on the national debt. Also, the national debt, unlike private debts such as home mortgages, does not have to be paid off. When the debt comes due, the government can simply borrow more money.

Economics does not provide an answer to Americans as to what they should do about federal budget deficits and the national debt. Ultimately, the people living in the United States must choose—based on their personal values—how much money they want to spend today and how much money they want to save for the future. The decisions of the present generation will affect the well-being of future generations.

U.S. Trade Deficits

The United States is a leading player in the global economy. The nation is the world's leading exporter, selling billions of dollars worth of goods and services to foreign buyers each year. The United States is also the world's largest importer. Americans buy vast quantities of foreign-made goods, such as cars, oil, and semiconductors.

For many years, the United States ran *trade surpluses*. In other words, the nation sold more products abroad than it bought from other countries. However, since the 1970s, the United States has imported more goods and services than it has exported, resulting in *trade deficits* (figure 4.3).

How Do Trade Deficits Affect the Economy?

Most experts are worried because Americans import more than they export. One reason for concern is that trade deficits may mean a lower standard of living for many U.S. workers. Trade deficits also drain money from the U.S. economy.

Trade Deficits Lower the Standard of Living. Workers in most other nations receive lower wages than American workers, allowing foreign firms to charge less for their products. For example, steelworkers in South Korea earn about $6.35 an hour, compared to about $11 an hour in the United States. During the 1980s, many workers in domestic industries facing stiff competition from abroad—such as steel and automobiles—took pay cuts to make U.S. products more competitive in price with imports. These pay cuts led to a lower standard of living for American workers.

In addition to the many workers who took pay cuts, more than 2.5 million U.S. workers lost their jobs to foreign competition in the 1980s. Some were laid off because sales of U.S. products declined overseas. Others lost their jobs because Americans bought goods from foreign rather than domestic firms. Most of the lost jobs were in high-wage manufacturing industries, such as steel and automobiles. In contrast, most new jobs being created in the United States are in the service sector of the economy. The service sector is broad—it includes doctors, lawyers, journalists, bus drivers, sales clerks, janitors, accountants, restaurant workers, and the like—but most jobs in the service sector tend to pay lower wages than jobs in manufacturing.

Trade Deficits Drain Money from the U.S. Economy. Another reason for concern is that trade deficits drain money from the U.S. economy. The United States must send dollars overseas to pay foreign companies for the goods Americans import. That money is then unavailable to Americans to invest in making the domestic economy more productive. If domestic companies had access to this money, they could expand industrial production and increase technological research to ensure economic growth and create jobs at home.

What Causes Trade Deficits?

Ironically, the United States helped create the conditions that caused its exports to decline. In some ways, current U.S. trade deficits resulted from the policy of the U.S. government after World War II. Experts also believe that low U.S. produc-

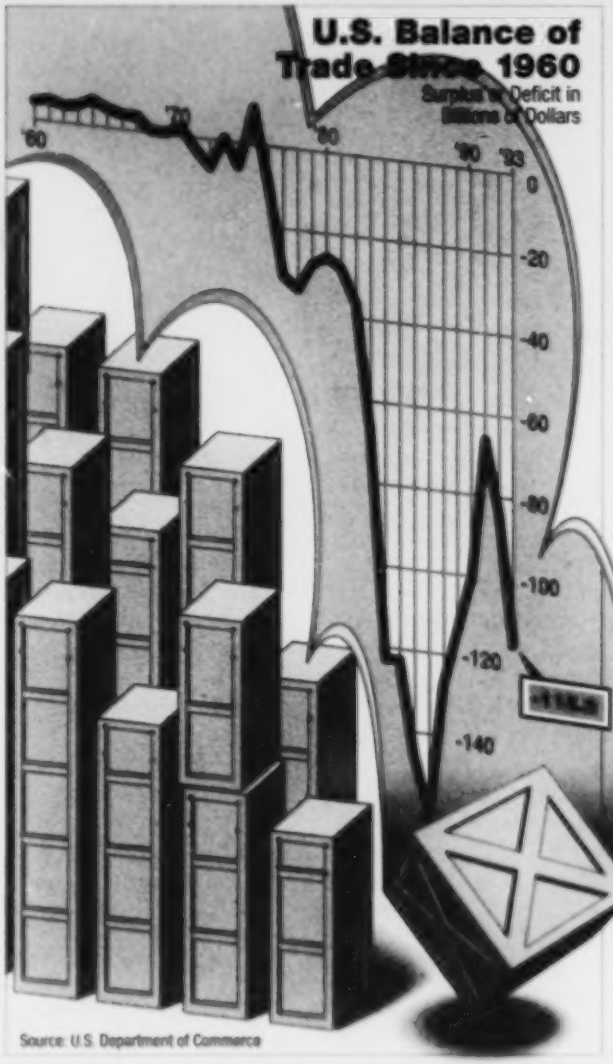

Figure 4.3

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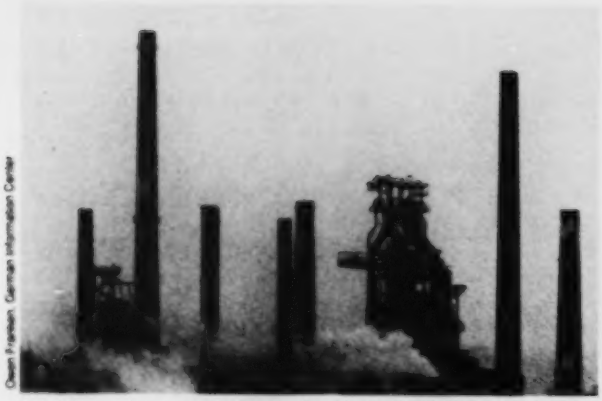


Owen Franken, German Information Center

This German factory was built after World War II with U.S. aid. American money helped the nations of western Europe and Japan recover from the war and ultimately compete with the United States in world markets.

tivity, large federal budget deficits, and high foreign trade barriers have contributed to U.S. trade deficits.

Successful Postwar Policy. After World War II, American manufacturers needed a worldwide market to keep the U.S. economy booming. The United States lent millions of dollars and gave technical assistance to Europe and Japan to help them rebuild. American leaders understood that if factories in foreign nations were not rebuilt, those nations would have suffered from high unemployment, and therefore would have been unable to buy American goods.

The United States also lowered its trade barriers after World War II, allowing more European and Japanese goods into the U.S. market. By buying foreign imports, the United States created jobs overseas and kept foreign workers employed. In turn, those foreign workers would have the money to buy U.S. goods. Thus, the U.S. economy became the engine of growth for the rest of the world.

Along with lowering its own trade barriers, the United States tolerated European and Japanese trade barriers erected after the war. U.S. leaders believed that the nation's allies needed time to rebuild their industries, and that when foreign companies had recovered from the war's devastation, those trade barriers would come down.

Japan and western Europe, with American help, recovered from World War II and began manufacturing high quality goods that cost less than U.S. goods. But as Japan and the western European nations rebuilt their economies, the U.S. economic lead narrowed. Thus, in some ways, the decline in U.S. exports reflects the success of U.S. foreign policy.

Low U.S. Productivity. Another reason for the U.S. trade deficit is low U.S. *productivity*. Productivity is the amount of goods and services a worker can produce in an hour. Since the 1960s, American productivity has lagged behind that of its main competitors, Germany and Japan.

Analysts say that U.S. productivity has lagged because foreign countries spend a larger share of their money in ways that make their economies grow. For example, Japan builds more factories, bridges, and laboratories each year than the United States. Japan and Germany also spend more money in researching and developing new technologies and products for the commercial market. By contrast, much of the research and development money spent in the United States has gone for military—not commercial—purposes. Similarly, schools in Japan and western Europe appear to be turning out students who are better prepared than their American counterparts to add to their nations' productivity.

Large Budget Deficits. Most experts think that large federal budget deficits also contribute to the U.S. trade imbalance. Government borrowing to finance budget deficits drives up U.S. interest rates. Foreign investors like to invest their money in countries with high interest rates. But to invest in the United States, foreigners must first convert their currency into U.S. dollars. During the 1980s, foreign demand for dollars was high, increasing the value of the dollar. The strong dollar in turn drove up the price of American products sold abroad, causing foreign consumers to buy fewer American-made goods. The high value of the dollar also reduced the cost of imports in the United States. American consumers took advantage of these low prices to buy more foreign goods and fewer domestic goods.

High Foreign Trade Barriers. Another cause of the U.S. trade deficit is the trade barriers put up by U.S. competitors. Many foreign trade barriers keep U.S. agricultural and manufactured exports out of overseas markets. Other types of trade barriers hurt U.S. exporters. For example, the United States, which produces vast amounts of grain, became the "breadbasket" of the world in the 1970s. But during the 1980s, U.S. farmers lost many foreign markets to European farmers whose governments subsidized exports of food, allowing Europeans to sell their produce overseas for lower prices.

What Can Be Done about U.S. Trade Deficits?

Many Americans, alarmed by continuing trade deficits, wonder how the United States can raise its exports and lower its imports. Experts suggest several solutions, such as increasing U.S. productivity, lowering the value of the dollar, raising U.S. trade barriers, and reducing foreign trade barriers.

Increase Productivity. Many analysts believe that the United States must increase the productivity of its workers. According to these experts, one way to increase productivity is to improve the education and training of present and future workers. In addition, many economists believe that spending more money on commercial, rather than military, research and development will help the economy grow faster, as will added investment in new factories, machines, highways, and ports.

Lower the Value of the Dollar. In the 1980s, many analysts argued that lowering the value of the dollar would help the U.S. trade deficit. A weak dollar makes U.S. products less expensive in foreign markets and raises the price of imports at home. So in 1985, the United States, with the cooperation of several other nations, lowered the dollar's value. The cheaper dollar helps U.S. exporters by making American-made goods cheaper abroad. However, the weak dollar hurts U.S. companies that depend on imported materials. And by making imports more expensive, the weak dollar contributes to inflation in the United States. The weak dollar also allows foreign companies to buy up American factories, farms, and office buildings at bargain prices.

For many years, Japan banned imports of rice to protect its own farmers. In 1994, the Japanese government lifted the ban.

Raise U.S. Trade Barriers. Many Americans believe that the United States should pursue a policy of protectionism. In other words, erect trade barriers to reduce the trade deficit. Advocates of protectionism argue that foreign companies have unfair advantages. They point to the fact that the United States allows more imports than other countries. In other words, U.S. companies may find foreign markets closed

What Is Productivity?

Productivity is the amount of goods produced per person per hour. A rising rate of productivity usually leads to higher wages, higher profits, and lower prices. Most economists agree that the best way for an industry to increase productivity is to invest in new, more efficient machinery and technological advances that will enable workers to produce more with the same amount of effort.

Governments use productivity rates as one way of monitoring the economic health of their nations. High productivity can mean high economic growth. Low productivity can mean a sluggish economy—fewer goods being produced at a higher cost. As a result, fewer goods are purchased by consumers, and unemployment increases.

In the years following World War II, U.S. productivity increased dramatically. From 1947 to 1965, productivity grew at an average rate of 3 percent per year. By the late 1960s, however, the nation's productivity growth had slowed. As a result, family incomes stagnated.

to their products, but the U.S. market open to foreign competition. And, many foreign companies—unlike most U.S. companies—receive subsidies from their home governments. Many people believe that the United States must raise its trade barriers to protect U.S. companies from unfair foreign competition.

Lower Foreign Trade Barriers. Other Americans think that the United States could reduce its trade deficit by getting other countries to lower their trade barriers. Some argue that American-made products are as good as foreign-made products and that U.S. companies simply need better access to foreign markets. Freer trade, according to its supporters, would increase U.S. exports and benefit American consumers by increasing competition.

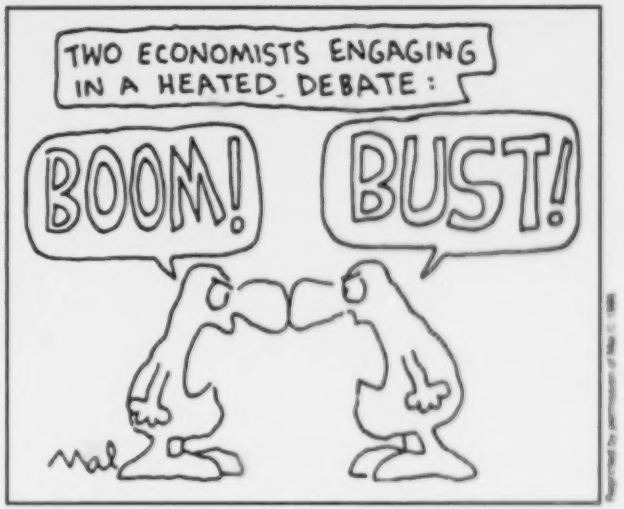
Economists disagree about what, if anything, the U.S. government should do to reduce the trade deficit. People who favor a limited role for government in the economy would prefer that trade

decisions be left to businesses. Others argue that the federal government must take the lead in reducing the trade deficit. Federal policymakers, guided by the wishes of the American people, ultimately must decide how to deal with U.S. trade deficits.

Looking Toward the Future

The United States faces many challenges as it enters the twenty-first century. Americans save and invest less than their economic rivals. Productivity growth in the United States lags behind that of its foreign competitors. The country's *infrastructure*—including its bridges and roads—is deteriorating. Twenty percent of 18-year-old Americans are functionally illiterate. One-fifth of America's children—its future workers—live in poverty. And the U.S. government must deal with serious budget and trade deficits.

However, the country has many advantages that will help it meet these challenges. The U.S. economy is still the world's largest, producing twice as much as its closest competitor, Japan. American workers turn out far more goods and services than workers in any other nation in the world. The world's fourth largest country in land area, the United States maintains jobs for nearly all of its 250 million people. The nation has an abundance of natural resources—iron ore, coal, and fertile soil—and a transportation system second to none. Other nations have succeeded in challenging the United States economically, and Americans can no longer claim that their country dominates the world economy as it once did, but they can still proclaim top status as producers and consumers.



Most experts agree that the United States can restore its competitive edge in the world marketplace, but that it will take hard work and team effort to retain its number one status. The choices Americans make today will determine whether their nation meets the challenges of the future.

Glossary

appropriation bill—bill providing funds for a government program

authorization bill—bill approving a government program

balanced budget—budget in which income equals expenses

budget deficit—amount by which expenses exceed income

budget surplus—amount by which income exceeds expenses

business cycle—recurrent ups and downs of the economy

capital resources—goods, such as tools, machines, or buildings, that are used to produce other goods

capitalist economy—see market economy

Congressional Budget Office—nonpartisan organization in the legislative branch that advises Congress on the federal budget

corporate income tax—tax that corporations pay on their profits

cost-push inflation—inflation that occurs when prices are pushed up by increases in the costs of producing products

customs duty—tax on imports (see also tariffs)

deficit spending—spending more money than the government takes in

demand—how much people are willing and able to buy of particular goods

demand-pull inflation—inflation that occurs when prices are pulled up by high demand

depression—prolonged slump in business activity marked by high unemployment

discount rate—interest rate the Federal Reserve charges banks for loans

dividend—share of a corporation's profits that are distributed to stockholders

easy money policy—policy in which the Federal Reserve expands the money supply, giving banks more money to lend. Easy money leads to increased demand and production, lower unemployment, and higher inflation

economic growth—production of more goods and services per person this year than last year

entitlement—benefit that is legally guaranteed to everyone who meets certain requirements

estate tax—tax on the estate (money and property) of someone who has died

excise tax—tax on the manufacture, sale, or use of certain products

expansionary fiscal policy—policy in which Congress and the president cut taxes and/or increase spending, giving consumers and businesses more money to spend and invest

exports—products sold to other nations

federal budget—U.S. government's plan for raising and spending money during its fiscal year

fiscal policy—government's use of taxing and spending to stabilize the economy

fiscal year—twelve-month accounting period; the federal government's fiscal year runs from October 1 to September 30 and is named after the calendar year in which it ends

fixed exchange rates—system in which the values of currencies are fixed by governments

floating exchange rates—system in which the values of currencies are determined by supply and demand

free trade—trade without restrictions

full employment—highest level of employment that is possible in an economy, occurring when only 4 percent of the labor force is unemployed

gift tax—tax on the transfer of money or property between living persons

goods—tangible products

gross domestic product (GDP)—total output of goods and services produced inside the nation

human resources—skills, talents, and knowledge that people use to produce goods and services

import quota—limit on the number of goods that may be imported during a certain time period

imports—products bought from other nations

individual income tax—tax on a person's yearly earnings

inflation—general rise in prices and wages resulting in a decrease in the purchasing power of the dollar

infrastructure—basic facilities needed by a community, such as bridges and roads

interest group—group of people with common interests organized to influence government decisions on issues

interest rate—price paid by businesses and consumers for using money secured through loans

laissez-faire—French term for "leave it alone"; in economic terms, *laissez-faire* means that the economic system of a nation is controlled by the laws of supply and demand with minimal government interference

market—place where people buy and sell products

market economy—economic system based on private ownership of property, production of goods for profit, and competition among producers; prices and wages are determined by the supply of and demand for a particular good or service; sometimes called capitalist economy

medium of exchange—any item that people accept as payment for goods and services

monetary policy—actions of the Federal Reserve System that increase or decrease the money supply

money supply—amount of money in circulation

monopoly—exclusive control by one seller of a particular good or service

national debt—total amount of money the federal government owes from past borrowing

natural resources—raw materials such as land, water, oil, timber, iron ore, or coal from which goods are made

nontariff barrier—trade barrier other than protective tariffs or import quotas

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open market operations—purchase or sale of U.S. government securities by the Federal Reserve

price-fixing—colluding to set the price of a product

productivity—efficiency with which goods and services are produced, as measured by the quantity produced per person per hour

profit—income after expenses

progressive tax—tax that takes a larger share of higher incomes than lower incomes

proportional tax—tax that takes the same percentage of high and low incomes

protectionism—trade policy that uses tariffs, quotas, or other restrictions to limit the amount of goods imported into the nation and therefore protects domestic industries from foreign competition

protective tariff—tax on imports designed to encourage the purchase of domestic goods by making imports more expensive

public goods—goods and services that the government provides for society as a whole

recession—period of slow economic activity marked by decreasing production, spending, and consumer demand, and increasing unemployment

regressive tax—tax that takes a larger share of low incomes than high incomes

reserve requirement—percentage of deposits that banks are required to keep on hand rather than lending

restrictive fiscal policy—policy in which Congress and the president raise taxes and/or decrease spending, giving consumers more money to spend and businesses more money to invest

revenue—income received

scarcity—condition that exists because people want more goods, services, and resources than are available; every society and individual must make economic choices because of scarcity

services—actions performed by people in exchange for something of value

Social Security tax—tax that finances payments to retired and disabled Americans

stagflation—inflation combined with high unemployment

standard of living—material well-being

standard of value—any item that allows people to measure the relative value of different products by comparing prices

stockholders—owners of a corporation

store of value—any item that can be saved for later use

subsidy—money given by government to an industry, business, or foreign government to encourage a certain activity; subsidies can take the form of low-interest loans, cash payments, or tax breaks

supply—how much of an item is available

supply-side economics—theory that government can promote economic growth by encouraging business to increase the supply of goods and services; government can encourage such increases through deregulation and the lowering of taxes

tax return—form listing income and taxes owed to the government

taxes—payments of money that people must make to the government

tight money policy—policy in which the Federal Reserve decreases the money supply, giving banks less money to lend; tight money leads to decreased demand and production, higher unemployment, and lower inflation

trade deficit—amount by which a nation's imports exceed its exports

trade policy—government's plan on how it will conduct economic relations with other nations; tariffs, quotas, and trade agreements are examples of the tools governments use in conducting trade policy

trade surplus—amount by which a nation's exports exceed its imports

transfer payment—gift of money from the government

unemployment—condition in which people are looking for work but cannot find jobs

unit of account—any item that enables people to keep records of the value of their property

U.S. government securities—the federal government's IOU's, such as U.S. savings bonds, treasury bills, and treasury notes

voluntary trade restriction—agreement in which foreign businesses "voluntarily" limit their exports

For Further Reading

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GOVERNMENT'S ROLE, CITIZEN'S CHOICE

SECOND EDITION

TEACHER'S GUIDE

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The American Economy

Government's Role, Citizen's Choice

Teacher's Guide

Developed by
Charles R. Sass

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To the Teacher

The American Economy: Government's Role, Citizen's Choice is designed to help your students understand how the economies of the nation and the world are influenced by choices made by individuals, groups, and governments. *The American Economy Teacher's Guide* offers classroom activities and handouts to promote active learning and enhance student understanding of the material covered in each chapter of *The American Economy*. In addition to reinforcing the facts, the activities require students to conduct independent research, evaluate, analyze, and synthesize information, and hypothesize about the future. Finally, the teacher's guide provides unit tests and answer keys to assist you in developing comprehensive lesson plans or units of study.

Goals

This guide should help your students to:

1. Understand and discuss the government's role in the U.S. economy.
2. Examine what actions the government takes to affect the economy.
3. Explore the federal budget process and the influence it has on the U.S. economy.
4. Examine what actions the government can take to attack the problems of budget and trade deficits.
5. Speculate on how the U.S. economy will perform in the future.

Structure of Units

The teacher's guide is divided into four units corresponding to the four chapters of *The American Economy*, unit tests, and an answer key. Each unit contains the following components:

Objectives

The student objectives include both cognitive and affective goals to help you measure student learning.

Key Terms

Key terms that students need to know to understand the concepts are presented in this section. The terms include italicized words defined in the glossary of *The American Economy* as well as names of important people and events. The following three activities will help reinforce student understanding of key terms.

1. Have a group of students develop a crossword puzzle using as many key terms from the unit as possible. Distribute copies of the puzzle to the students, and have them complete it as a review exercise before they take the unit test.
2. Divide students into groups of three or four. Assign each group ten key terms, which they are to use in a rap, a poem, or a short story. Ask students to present their creations to the class, making sure that their fellow classmates will be able to understand the meaning of the key terms from listening to the presentations.

3. Photocopy definitions of the key terms from the glossary of *The American Economy*. Then, cut out the definitions and place them in a hat or bowl. Divide students into two or more teams. Have teams alternate drawing out one of the definitions and trying to identify the key term associated with it. Award each team one point for a correct answer. If the team that chooses the definition cannot name the correct key term, another team may try to identify it for two points. At the end of the game, the team with the most points wins—and the entire class will have reviewed all key terms.

Motivator

The motivator is an activity designed to capture student interest, introduce the class to each new chapter of *The American Economy*, and encourage active participation by the entire class.

Student Activities

Each unit contains three student activities that require students to exercise their critical-thinking skills and do independent research. The activities also emphasize important information from the corresponding chapter of *The American Economy*.

Unit Tests

This section of the guide contains a variety of test questions that you can use as a ready-made test, as a student self-check test, or as a source for making your own tests. The tests include true/false, multiple-choice, fill-in-the-blank, and essay questions taken from information presented in *The American Economy*.

Answer Key

This section includes answers to all unit test questions.

Teacher Notes for Student Handouts

This section includes answers to student handout items where appropriate.

Student Handouts

Student handouts for each unit can be reproduced for classroom use. Each handout is keyed to a student activity.

Unit 1
Government's Role in the Economy

Objectives

After completing this unit, students should be able to:

1. List U.S. economic goals and explain ways the government attempts to achieve them.
2. Identify ways in which the government is involved in the nation's economy.
3. Discuss the historical evolution of government involvement in the economy.
4. Compare and contrast economic philosophies of important economists and U.S. presidents.

Key Terms

capital resources
cost-push inflation
demand-pull inflation
depression
human resources
laissez-faire
market (capitalist) economy
price-fixing
public goods
gross domestic product (GDP)
recession
stagflation
subsidies
transfer payments

Motivator

Before students read Chapter 1 in *The American Economy,* ask them to brainstorm common daily activities that are influenced by the federal government. They may consider influences such as food and drug laws, FCC regulations, environmental standards, and safety regulations. Challenge students to come up with as many federal laws, programs, and agencies they can think of that might affect them on a day-to-day basis. Jot down their responses on the board as they are presented. Then, briefly discuss each of their responses. What is the purpose of each law, program, or agency? Keep the list of responses on the board; you will use them in a later activity.

Student Activities

1. After students have read Chapter 1, "Government's Role in the Economy," hand out **Student Handout #1—Economic Survey.** Allow them five to ten minutes to complete the handout. Then, poll the class as you proceed through each statement on the handout, asking for a show of hands. Record on the board how many agree with each statement and how many disagree—as well as those who are undecided. Do not stop to discuss each statement while conducting the poll—merely record votes. After completing the poll, lead a discussion about each of the handout items. Ask students who are on opposite sides to defend their positions.

   After discussing each item on the handout, students will probably realize that the government is heavily involved in the economy. Now, refer students back to the items on the board that they mentioned during the motivator activity. Which of those items have anything to do with the economy? Erase responses that are unrelated to the economy, and add to the list. What other laws, agencies, regulations, and so forth can students think of that affect the economy? Conclude by emphasizing that the government is indeed heavily involved in the U.S. and world economies.

2. Divide the class into five groups, each representing one person mentioned in Chapter 1 of *The American Economy*: Adam Smith, John Maynard Keynes, Franklin Roosevelt, Lyndon Johnson, and Ronald Reagan. Ask each group to research their historical figure and prepare a one-page report to read to the rest of the class. They should tell something about the man's life, emphasizing his ideas about the economy and what he did to influence it. Each group should select one person to read the report to the rest of the class.

   Extend this activity by setting up a role-playing scenario. Each group can select one member to play the role of the character about whom they studied. With the five characters seated in front of the class, they can field questions from other students as if they were holding a news conference. Prepare the rest of the class by having them write down one question about government involvement in the present-day U.S. economy. You should serve as the moderator, allowing follow-up questions and urging other members of the panel to react to the original respondent.

3. Divide students into six groups, and ask each group to prepare a wall poster representing one of the economic goals outlined in figure 1.2—"U.S. Economic Goals." Each poster should depict the actions usually taken by the government to achieve that particular goal. Students should combine words and pictures to make their posters clear. They may want to clip pictures from magazines or newspapers, take photos that show a government action designed to reach an economic goal, or create original art that will make the point. Urge students to use their imaginations, keeping in mind that when others look at their poster, they should have no questions about what the poster is trying to depict.

   When the posters are complete, hang them around the classroom and ask one member of each group to tell something about their poster and the importance of the economic goal it represents.

Unit 2
How Government Affects the Economy

Objectives

After completing this unit, students should be able to:

1. List ways in which the U.S. government affects the nation's economy.
2. Define money and explain how it applies to monetary policy.
3. Discuss the choices available to officials who make fiscal policy.
4. Compare and contrast free trade and protectionism.

Key Terms

discount rate
easy money policy
expansionary fiscal policy
fiscal policy
fixed exchange rate
floating exchange rate
import quotas
monetary policy
protective tariffs
reserve requirements
restrictive fiscal policy
tight money policy
trade policy

Motivator

Before students read Chapter 2 in *The American Economy,* ask them to write four responses to the question: "What is money?" Give them five minutes to write their answers. Then, ask them to volunteer their answers. List their responses on the board. After you have listed a representative number of answers, lead a discussion about money. Use the information on page 24 of *The American Economy* under "Monetary Policy" as a focus for the discussion. Were student responses similar to the descriptions of money in *The American Economy?*

Student Activities

1. Begin this activity by briefly discussing fiscal policy. Refer to "Which Fiscal Policy?" on page 27 of *The American Economy* and any other materials you wish to bring to class. Explain the differences between expansionary fiscal policy and restrictive fiscal policy, and point out examples when both have been used by federal lawmakers. After a short discussion, distribute **Student Handout #2—Campaign Speeches,** and ask students to write a short campaign speech for each candidate. Use your judgment as to how much time to allow—either making it an in-class assignment or using it as homework.

   When students have completed the handout, ask some or all of them to read their speeches in class. When a representative number of speeches have been read, ask the class to comment on the policy they personally favor. Which policy is most appealing? Which economic problem is worse—inflation or unemployment? Should taxes be cut? Should they be raised? Should government cut spending? If so, what should be cut?

   Conclude by asking for a show of hands favoring one policy or the other. Count the votes and write the results on the board. Which candidate would win based on the class poll?

2. After students have read the "Trade Policy" section in *The American Economy*, distribute **Student Handout #3—Which Trade Policy?** Divide the class into pairs, and have them work on the handout together. Remember, you have not spent much time discussing this subject, so they are basing their answers on what they have read in *The American Economy* and what knowledge they bring with them. There are no "right" answers or "wrong" answers, but there are logical choices. You might want to point this out to students while they are working.

   After students have finished, go through each item, and ask each pair what they decided and why. Keep track of the responses on the board. After each pair has responded to an item, discuss which choice would most likely be true. Explain how protectionism or free trade would affect each person. "Teacher Notes for Student Handout #3" should help you. There may not be a clear-cut decision for several of these fictional Americans; point out how students might be torn between the two choices. For example, an Iowa grain farmer may benefit from free trade by being able to buy farm machinery at a lower price, but on the other hand, the farmer may want the government to keep cheap foreign grain out of the United States.

   Conclude by focusing on the last American on the list—the high school student in their state. How many students favor protectionism? How many favor free trade? Why? Does their locale or the occupation of their parents have anything to do with their decisions? Are any students undecided? If so, ask them why they cannot make up their minds. Point out that government officials often face the same dilemma when trying to set trade policies.

   Extend this activity by organizing a classroom debate on the following statement: "To help the U.S. auto industry, tariffs and quotas should be imposed on cars being exported to the United States from Japan and Germany." Organize the debate any way you see fit. You may want to form two groups of interested students on each side of the question with each group choosing one debater, or all members of a group may want to speak for a limited time period. Select a moderator to keep time and order and to keep the debate moving.

3. In some countries, the governments make all the economic decisions. Such governments decide what will be produced, how much will be produced, and at what price it will be produced. Although the U.S. government has usually played some role in regulating the economy, individuals are allowed to make most of the decisions. Americans have differing opinions about the level of government regulation in economic matters. Write the following statements on the board, and lead a discussion about each.

   The government should promote employment by:

   - buying goods or services it does not need.
   - subsidizing noncompetitive industries.
   - taking over businesses that are losing money and about to close.
   - increasing business tax breaks.
   - relaxing government standards for environmental protection, employee safety, and product safety.
   - setting quotas on how much a company can produce.
   - regulating prices.

   Do students agree or disagree with the statements? Why? Do they have any other ideas about what the government should or should not do to regulate the economy?

Unit 3
The Federal Budget and the Economy

Objectives

After completing this unit, students should be able to:

1. List the major players in the budget process and explain the role of each player.
2. Discuss why it is difficult for federal officials to agree on the annual federal budget.
3. Explain the basic procedures of the federal budget process.
4. Describe the types of taxes used by the federal government to raise revenue.

Key Terms

appropriation bill
authorization bill
corporate income tax
customs duties
estate tax
excise tax
fiscal year
gift tax
individual income tax
progressive tax
proportional tax
regressive tax
revenue
Social Security tax

Motivator

Write the following statement on the board: "If I were in charge of making the federal budget, I would _____." Then, in a brainstorming session, have students complete the statement with short, quick responses. Write down their responses as they are presented. After you have compiled a fairly long list, ask your class to see if they can detect any patterns. Examine each response, and decide what it deals with. Does it call for spending reductions? Spending increases? Tax reductions? More defense spending? More spending for low-income Americans? Point out the diversity of thinking in your small group, and then emphasize how difficult it is for Congress and the president to arrive at a consensus each year as they try to come up with a new budget.

Student Activities

1. Distribute **Student Handout #4—Making the Federal Budget** to the class, and divide students into pairs. Ask each pair to complete the handout, using the "Making the Federal Budget" section of *The American Economy* along with any knowledge they may bring with them from the outside. You may want to have them complete the handout as an in-class activity or as a homework assignment.

   After students have finished the handout, lead a discussion based on the information students have gathered. Discuss each player in the budget process—who they are and what they do as the budget is being put together. Ask them which of the players they think is the most important and which is least important. Discuss why they think the budget process has to be so long and complicated. The "Teacher Notes for Student Handout #4" should help you lead the discussion.

   Extend this activity by asking students to clip articles from newspapers and magazines referring to any aspect of the budget. While students are clipping articles, create five columns on a bulletin board, each headed by one of the five major players listed on the handout. Then, as articles come

in, ask students to pin them under the appropriate head. Encourage students to scan the articles as they appear—or discuss each one briefly before it goes on the board.

2. Write the following list of budget items on the board:

   (1) B-2 bombers

   (2) CIA funding

   (3) military aid to the Middle East

   (4) humanitarian aid to Africa

   (5) space mission to Mars

   (6) funding for national parks

   (7) Medicare

   (8) student loans

   (9) food stamps

   (10) salary increases for government workers

   Distribute **Student Handout #5—A Framework for Examining Federal Budget Items,** and assign one of the budget items to each student by having them count off by ten. Have students with the same budget item work together. Allow the class enough time to analyze their budget items, using the handout as a guide. Emphasize to students that they are going to argue for funding for their budget item to the rest of the class; therefore, whether they personally agree or disagree with the worth of the item, they should present the best arguments they can think of.

   After students have completed the handout, ask a spokesperson from each group to present arguments as to why his or her item should be funded. Keep the presentations short, urging students to present the facts they have listed on their papers without a lot of extra comment.

   After all presentations have been made, tell students that only seven of the ten budget items can actually be funded this year. Ask students to choose three items they would cut and raise their hands each time one of the three items is mentioned. Go through the list, asking for a show of hands and recording the tally on the board. Were the final cuts a surprise to the class? What does this experience tell them about the federal budget process?

   To extend this activity and study the budget process in more detail, you may want to obtain a copy of Close Up Publishing's simulation activity *Slicing the Pie: A Federal Budget Game*.

3. Divide the class into six groups, and assign each group to research and write about one kind of federal tax. The taxes to be considered are:

   - individual income tax
   - Social Security tax
   - corporate income tax
   - excise tax
   - estate and gift tax
   - customs duties

Tell students that they should find out all they can about the tax they are assigned and prepare a one-page report to present to the class. Each group may divide the work any way it sees fit. The reports should include information about (1) the history of the tax, (2) the amount of money it raises each year, (3) the people it most affects, (4) whether it is progressive or regressive, and (5) how the tax is collected. Ask them to conclude their reports with a brief statement about how they as a group felt about the tax and its value and fairness.

When the reports have been written, each group should choose a spokesperson to present its report to the rest of the class. Encourage other students to ask questions when the reports are finished. Conclude by asking students if they have changed their minds about taxes after hearing this information. What taxes would they be willing to pay more of? Less of? Can they think of any type of new tax that would be more fair and less painful to the average citizen?

Unit 4
Today's Choices, Tomorrow's Legacies

Objectives

After completing this unit, students should be able to:

1. List and describe the measures that could be taken to deal with the federal budget deficit and U.S. trade deficits.
2. Discuss strengths and weaknesses of methods that could be used to lower the budget deficit.
3. Discuss strengths and weaknesses of methods that could be used to reduce the trade deficit.
4. Speculate on the condition of the U.S. economy at the end of the twentieth century.

Key Terms

deficit spending
entitlements
infrastructure
productivity
trade deficit
trade surplus

Motivator

Begin by telling students that in ten years they will be in their middle to late twenties and likely will be on their own and in the workforce. Then, read the following statements and, with a show of hands, ask them if they agree or disagree with each one. Record their responses. Follow with a brief discussion of their opinions. Ask why they think as they do. Encourage students who disagree to state their reasoning. Why are some optimistic and some pessimistic?

- I will make more money than my parents make.
- I will enjoy a higher standard of living than my parents do.
- I will receive a better education than my parents did.
- I will live in a nicer house than the house in which my parents live.
- I will pay a larger share of my income in taxes than my parents do.
- I will have to move away from here to get the kind of job I want.
- The economy of the United States will be better in the twenty-first century than it was toward the end of the twentieth century.
- The federal budget will be balanced by the twenty-first century.
- The trade deficit will be reversed by the twenty-first century.
- The overall standard of living in the United States in the twenty-first century will be better than it is now.

Student Activities

1. Divide your class into three groups, each of which will consider one of the following ways of dealing with the budget deficit: (1) cut spending, (2) raise taxes, or (3) accept deficits. (If your class is too large for just three groups, you may want to divide them into six groups with two groups considering each of the choices.)

   After groups are assembled, tell them to prepare an argument for dealing with the budget deficit using the means they were assigned. They will present their arguments in a one-page speech justifying their position. Students should read the appropriate sections in *The American Economy* and use any outside information they might find. Each group should select one student to present the speech in front of the class.

   After each group's speech has been delivered, students will participate in a news conference. All members of the appropriate group should be seated in front of the room and be prepared to respond to questions from the rest of the class.

   After all groups have had their say, conclude by asking students which position was most appealing and which was least appealing. Point out the difficulty federal lawmakers and officials have in dealing with the same question of how to handle the deficit.

2. Inform students that they have just been appointed to the president's Council of Economic Advisers. The president has warned them that the continuing high trade deficit threatens the economic well-being of the nation. Jobs are being lost, tax revenues are decreasing, and the general health of the economy is being threatened. The president has identified four possible solutions for addressing the problem:

   (1) helping U.S. industry increase productivity,

   (2) intervening in currency markets to reduce the value of the dollar,

   (3) instituting protectionist measures, or

   (4) balancing the federal budget.

   However, the president does not want his advisers to act as advocates for any one particular solution. He wants them to investigate the pros and cons—costs and benefits—of his possible solutions and report their findings back to him (and to the rest of the class).

   Divide the class into four groups, each investigating one of the solutions. To help with this project, students should complete **Student Handout #6—Plan for Reducing U.S. Trade Deficits** with half of the group looking for strengths of the approach and the other half looking for weaknesses. Remind students that the purpose is not to convince other group members that their position is the right one, but simply to gather as much information as possible to present to the president and to the class. Each group should recommend a specific policy—for example, how the government will help industry increase its productivity—and evaluate the usefulness of that policy.

   After all groups have had sufficient time to research their topic, have them share their findings with the class. Lead a discussion on the value of each approach. Ask the class to attempt to arrive at a consensus for dealing with the trade deficit.

3. Distribute **Student Handout #7—U.S. Economy Since 1985** and allow students time to complete it. You may want to use the handout as a homework assignment or as an in-class activity. When students have finished the handout, review their answers to the questions. Urge discussion among students who disagree, and find out their rationale for answering the way they did. In discussing the handout, stress the complexity of economic issues and the need to examine all indicators before making a judgment. Also point out that some economic indicators may look more favorable than they really are. For example, government spending may help keep unemployment down, but may ultimately contribute to the budget deficit.

   Have students look for relationships among the statements—low inflation and economic expansion, tax rates and budget deficits, trade barriers and trade deficits. After discussing the statements and their answers to the questions, ask them to read their rewrites to the statements as if it were 2010. Have students revised most of the statements? Are students generally optimistic or pessimistic? Ask them to explain why they rewrote each statement as they did.

Unit Test Materials

Unit 1
Government's Role in the Economy

True/false: Use T for true and F for false, and place your answer in the blank. Use the space below the item to correct any statements you think are false.

____ 1. Capital resources such as fertile soil and abundant coal have helped make the economy of the United States strong.

____ 2. The United States has a market or capitalist economy.

____ 3. The government helps provide a stable economy by passing laws to protect the rights of consumers, workers, and businesses.

____ 4. John Maynard Keynes proposed a *laissez-faire* position toward government intervention in the economy.

____ 5. The Federal Trade Commission (FTC) was established under Franklin Roosevelt's New Deal to prevent unfair business practices such as false advertising.

Multiple Choice: Circle the letter preceding the best choice.

6. The first federal regulatory agency was:

   a. the Food and Drug Administration.
   b. the Federal Trade Commission.
   c. the Interstate Commerce Commission.
   d. the Environmental Protection Agency.

7. The economic term most closely associated with the presidency of Ronald Reagan is:

   a. supply-side economics.
   b. New Deal.
   c. war on poverty.
   d. Great Society.

8. A continuing rise in prices for goods and services is called:

   a. recession.
   b. depression.
   c. stagflation.
   d. inflation.

9. Unemployment that results from weather-related changes in demand for certain products is called:

   a. seasonal unemployment.
   b. frictional unemployment.
   c. cyclical unemployment.
   d. structural unemployment.

10. The U.S. economic goal that seeks to raise the nation's standard of living is called:

    a. economic efficiency.
    b. economic security.
    c. economic growth.
    d. economic equity.

Fill in the blank: Complete each statement.

11. An increase in unemployment combined with a nongrowing economy produces a condition known as _____ .

12. Gifts of money made by the government to unemployed or older people are called _____ .

13. Government payments of money to promote business activities are called _____ .

14. A long-lasting economic slowdown is known as a _____ .

15. President _____ promised to invest money in job training and education to help U.S. workers compete in the twenty-first century.

Essay: Write a complete answer for each of the following.

16. How does demand-pull inflation differ from cost-push inflation?

17. The government sets certain economic goals for the nation; however, those goals may conflict at times. Give an example where economic goals may conflict and explain why.

18. Define "monopoly," tell whether it is a good or bad situation, and explain why.

19. Most prices in the United States are determined by the supply of and demand for a product or service. Define supply and demand, and explain how they can determine prices.

20. How would Franklin Roosevelt and Ronald Reagan respond differently to an attempt by Congress to pass a law that would guarantee each family of four in the United States an annual income of $5,000? State their likely positions, and explain why you think they would take such a position.

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Unit 2 How Government Affects the Economy

True/false: Use T for true and F for false, and place your answer in the blank. Use the space below the item to correct any statements you think are false.

____ 1. The Federal Reserve System tries to control the economy by regulating the money supply.

____ 2. The reserve requirement refers to the amount of money the federal government must keep in the treasury at all times.

____ 3. A U.S. savings bond could be called a government IOU.

____ 4. John Maynard Keynes believed that recessions occur because spending in the economy is too low.

____ 5. An increase in government spending is likely to cause a rise in unemployment.

Multiple Choice: Circle the letter preceding the best choice.

6. A restrictive fiscal policy is likely to:

a. reduce inflation.
b. cause unemployment to fall.
c. increase inflation.
d. cause stagflation.

7. Fiscal policies are more vulnerable to political pressures than monetary policies because:

a. the Federal Reserve Board reflects the wishes of the president.
b. fiscal policy is set by elected officials.
c. monetary policy is set by elected officials.
d. Congress and the president often agree on fiscal policies.

8. The government can restrict imports by:

a. imposing protective tariffs.
b. setting import quotas.
c. setting voluntary trade restrictions.
d. doing all of the above.

9. The government can promote exports by:

a. erecting nontariff barriers.
b. loaning money to foreign companies.
c. lowering the value of the dollar.
d. forcing up the value of the dollar.

10. The nation's central bank is known as:

a. the Federal Reserve System.
b. the United States Treasury.
c. the World Bank.
d. the First National Bank.

Fill in the blank: Complete each statement.

11. The interest rate that the Fed charges banks for the use of its money is known as the _____ rate.

12. Products that the United States buys from other nations are called _____.

13. A limit on the amount of foreign goods that can be brought into the United States is called a _____.

14. A trade policy that is the opposite of protectionism is known as _____ trade.

15. Money that the government collects from its citizens is called _____.

Essay: Write a complete answer for each of the following.

16. List and describe four important functions served by money.

17. Describe how monetary policy differs from fiscal policy.

18. Explain why neither monetary policy nor fiscal policy can fight unemployment and inflation at the same time.

19. If most experts claim that free trade promotes the economy more effectively than protectionism, why would any country pursue a policy of protectionism?

20. List and describe three factors that complicate government efforts to manage the economy.

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Unit Test Materials

Unit 3
The Federal Budget and the Economy

True/false: Use T for true and F for false, and place your answer in the blank. Use the space below the item to correct any statements you think are false.

____ 1. The U.S. government's fiscal year runs from January 1 to December 31.

____ 2. By law, Congress must approve the president's budget in the form it is presented to Congress.

____ 3. Social Security taxes are commonly withheld from a person's paycheck, as are individual income taxes.

____ 4. According to the Constitution, only Congress has the power to raise and authorize spending of government funds.

____ 5. Corporate income taxes bring in the largest amount of revenue for the federal government.

Multiple Choice: Circle the letter preceding the best choice.

6. Taxes that take a larger share of low incomes than high incomes are called:

a. progressive taxes.
b. excise taxes.
c. regressive taxes.
d. customs duties.

7. The federal government borrows money from:

a. the U.S. treasury.
b. the American people.
c. foreign investors.
d. both b and c above.

8. The largest share of federal spending goes for:

a. direct benefit payments for individuals.
b. interest payments on the national debt.
c. national defense.
d. payments to cities, counties, and states.

9. The director of the Office of Management and Budget (OMB) reports directly to:

a. Congress.
b. the secretary of the treasury.
c. the speaker of the House.
d. the president.

10. All authorization and appropriation bills must be passed by Congress and signed by:

    a. the president.
    b. the speaker of the House.
    c. the president *pro tem* of the Senate.
    d. the director of the Internal Revenue Service.

Fill in the blank: Complete each statement.

11. Congress actually provides money for a federal program by passing a separate _____ bill.

12. Interest groups often resort to a practice known as _____ to influence members of Congress.

13. Income raised by the federal government is called _____.

14. By April 15 of each year, Americans must file a _____ to the Internal Revenue Service.

15. Taxes laid on the manufacture, sale, or use of certain products within the United States are called _____ taxes.

Essay: Write a complete answer for each of the following.

16. Explain why federal spending that goes for direct benefits payments to individuals has gone up dramatically since 1960.

17. Explain how government taxing and spending profoundly affect the U.S. economy.

18. Describe the president's role in preparing the federal budget.

19. What is the "Washington Monument Game," and why is it used?

20. Explain the difference between a progressive tax and a regressive tax.

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Unit Test Materials

Unit 4
Today's Choices, Tomorrow's Legacies

True/false: Use T for true and F for false, and place your answer in the blank. Use the space below the item to correct any statements you think are false.

____ 1. At the end of World War II, the United States was the dominant economic power in the world.

____ 2. The United States is now the world's largest creditor nation.

____ 3. It has been only in the last ten years that the U.S. government has operated with an unbalanced budget.

____ 4. Before 1970, the United States consistently ran trade surpluses, selling more goods overseas than it bought.

____ 5. After World War II, the United States helped Europe and Japan rebuild.

Multiple Choice: Circle the letter preceding the best choice.

6. Trade deficits are caused by:

a. low productivity.
b. high budget deficits.
c. high foreign trade barriers.
d. all of the above.

7. When the value of the U.S. dollar is lowered:

a. U.S. products become more expensive in foreign markets.
b. foreign imports become higher priced in the United States.
c. U.S. exporters are hurt because American-made goods are cheaper abroad.
d. inflation is reduced in the United States.

8. The world's largest economy is that of:

a. Germany.
b. Japan.
c. Russia.
d. the United States.

9. Budget deficits can be lowered by:

a. cutting government spending.
b. raising taxes.
c. lowering taxes.
d. both a and b above.

10. Productivity can be increased by:

    a. improving the education and training of workers.
    b. spending less on research and development in nonmilitary industries.
    c. investing less in new factories and machines and more in fixing up old factories.
    d. moving U.S. factories to foreign countries.

Fill in the blank: Complete each statement.

11. America's bridges and roads make up part of what is commonly called its _____.

12. In 1941, *Life* magazine christened the twentieth century the "_____ century."

13. When a government takes in less ... ney than it spends, it must _____ money to make up the difference.

14. The government has to compete with private borrowers for limited funds in the United States because Americans are notoriously poor _____.

15. Most of the uncontrollable government spending goes for _____, such as Social Security and Medicare.

Essay: Write a complete answer for each of the following.

16. Explain why the federal government cannot go bankrupt.

17. List and describe three reasons why budget deficits are generally considered bad for the country.

18. List and describe two reasons why trade deficits are generally considered bad for the country.

19. Discuss what experts generally consider to be the reasons why U.S. productivity growth lagged behind that of its world industrial competitors during the 1970s and 1980s.

20. Discuss what the United States and Americans can do to restore their competitive edge in the world marketplace.

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Answer Key

Unit Tests

Unit 1

1. F—Fertile soil and abundant coal are natural resources, not capital resources.
2. T
3. T
4. F—Adam Smith favored *laissez-faire*. Keynes advocated government intervention in the economy.
5. F—The FTC was established in 1914, long before Roosevelt's New Deal.
6. c
7. a
8. d
9. a
10. c
11. stagflation
12. transfer payments
13. subsidies
14. depression
15. Clinton
16. Demand-pull inflation occurs when prices are pulled up by high demand; prices go up when people have money to spend. Cost-push inflation occurs when prices are pushed up by high production costs; prices go up when business costs go up.
17. Students' answers may vary. For example, students may discuss the conflict between economic equity and economic security when what Americans consider fair (equity) clashes with economic freedom. Americans are not free to pursue their economic goals because part of their income is taken by the government to give to low-income, unemployed, and retired people.
18. Monopolies occur when only one business makes or sells a product or service. Such a situation is generally considered bad because the company with the monopoly has no competition, and thus can charge whatever it wants for its product.
19. Supply refers to the amount of a product available to consumers. Demand refers to the amount of a product consumers want. Too much supply makes the price of a product go down; too much demand makes the price go up.

20. Roosevelt would likely favor the proposal; Reagan would likely oppose it. Roosevelt believed government should do all it could to reduce inequality and attack poverty. Reagan believed government interference caused economic problems and that if left alone, business would thrive and poverty would be eliminated.

Unit 2

1. T
2. F—The reserve requirement refers to the the percentage of deposits that banks must keep on hand rather than lending.
3. T
4. T
5. F—An increase in government spending is likely to cause a rise in inflation but a drop in unemployment.
6. a
7. b
8. d
9. c
10. a
11. discount
12. imports
13. quota
14. free
15. taxes or revenue
16. *medium of exchange*—People accept money as payment for goods or services.

    standard of value—People can measure the relative value of different goods and services by comparing the prices of each.

    unit of account—People can keep records of the value of their property as expressed in terms of the dollar.

    store of value—People can save money for later use.
17. Monetary policy refers to the regulation of the money supply—the amount of money in the economy. Monetary policy is entrusted to the Federal Reserve System. Fiscal policy refers to the

government's taxing and spending powers to either put more money into the economy or take money out. Congress and the president develop fiscal policy.

18. Both monetary and fiscal policies either make more money available to the economy or take money out of the economy. When money is put into the economy, inflation tends to rise because business increases and people have more money to spend. When money is taken out of the economy, unemployment tends to rise because business slows. Both policies hope to find some middle ground where neither inflation nor unemployment get out of hand.

19. Countries generally pursue protectionism to protect their domestic industries that have to compete with foreign industries. Domestic industries put pressure on their government officials to keep foreign products out so that they can prosper. Officials impose protectionist policies at the expense of domestic consumers, who must pay higher prices. But consumers are often willing to pay higher prices to make sure their home industries stay in business. Protectionism is sometimes imposed to retaliate against foreign nations that protect their own businesses by keeping out foreign goods.

20. Students can cite any **three** of the following factors:

    Forecasting problems—Officals often have trouble predicting the future of the economy. Accurate statistics are slow to come by.

    Timing problems—Changing policies can be a slow, complicated procedure that may come too late to affect the problem it was originally supposed to solve.

    Coordination problems—Federal officials may not work together very well because they target different problems. The Fed, Congress, and the president may all aim at different economic problems, thus pursuing their own agendas.

    Unpredictable economic behaviors—Government officials can forecast a problem and act on it, but the problem may never come about. Americans make thousands of economic decisions every day, and finding a trend is often difficult.

Unit 3

1. F—The government's fiscal year runs from October 1 to September 30.

2. F—Congress develops its own budget and negotiates with the president to reach a final form that both branches can live with.

3. T

4. T

5. F—Individual income taxes bring in the largest amount of revenue.

6. c

7. d

8. a

9. d

10. a

11. appropriation

12. lobbying

13. revenue

14. tax return

15. excise

16. The number of people eligible for benefits is increasing every year. And, benefits such as Social Security have automatically increased at the same rate as inflation.

17. A great deal of money spent by the government is used to buy goods and services produced by American companies and workers. That money has great influence on the prosperity of U.S. companies that do business with the federal government, the employees of those companies, and ultimately the whole nation.

18. The president must, by law, propose a budget to Congress in January for the upcoming fiscal year. The president delegates the budget responsibility to the director of the Office of Management and Budget (OMB). The OMB reflects the wishes of the president when it prepares the budget. The president must also sign the final budget passed by Congress; therefore, the budget that comes from Congress must meet the president's approval or he or she may refuse to sign it.

19. Federal agencies, in an effort to convince Congress of their budget needs, sometimes threaten to close down popular programs for lack of funds. For example, the National Park Service may tell Congress that if they do not get the funds they requested, they may have to close the Washington Monument to tourists. This, of course, is unpopular with the public—whom Congress must answer to—and thus, the money is usually appropriated.

20. A progressive tax takes a larger percentage of high incomes than low incomes. In other words, the wealthy—who can afford to pay more taxes—end up paying more under a progressive tax. Regressive taxes take a larger share of low incomes than high incomes.

Unit 4

1. T

2. F—The United States is the world's largest debtor nation.

3. F—The U.S. government has run a budget deficit most years since 1930.

4. T

5. T

6. d

7. b

8. d

9. d

10. a

11. infrastructure

12. American

13. borrow

14. savers

15. entitlements

16. Because the government has the power to issue money and to tax, the government can always meet its interest payments on the national debt. The national debt does not have to be paid off. When the debt comes due, the government can simply borrow more money.

17. Budget deficits are bad because they:

    Limit use of fiscal policy—In other words, Congress and the president cannot readily lower taxes or cut spending without increasing the national debt and adding to the deficit.

    Dampen economic growth—The government has to borrow money to pay interest on the national debt, which leaves less money for private business to borrow. This also drives up interest rates, which keeps businesses from expanding.

    Force dependence on foreign money—The U.S. government must finance its debt by borrowing money from foreign investors, making the nation the world's largest debtor nation. The interest paid on that foreign money leaves the United States and enriches its foreign competitors.

    Affect the country's future—Some experts think the future of the nation is jeopardized because the money being spent by the government is not being spent to make the country more productive. In other words, the money is not being spent on roads, education, and research, but rather to pay interest on the national debt.

18. Trade deficits:

    Lower the standard of living—American workers have lost many high-paying industrial jobs to foreign competitors because sales of U.S. goods have declined overseas and because Americans buy more foreign goods than domestic goods. American workers who lose high-paying jobs often are forced to take lower-paying jobs instead.

Drain money from the U.S. economy—The United States has to send dollars overseas to pay foreign companies for the goods Americans import. That money is then unavailable for domestic investments that could build new factories and create more jobs.

19. Many analysts say that U.S. productivity lagged because foreign countries spent a larger share of their money to build more factories, bridges, roads, and laboratories; to conduct research and development of new technologies; and to train workers to perform more complicated tasks.

20. Students' answers may vary; however, they should point out that most experts think Americans will have to produce more than they spend and improve their savings habits. Americans will have to improve education, rebuild the nation's infrastructure, improve worker productivity, and spend money for research and development of new technologies. Students may add other valid points.

Teacher Notes for Student Handouts

Student Handout #3

1. A Georgia textile mill worker would likely favor protectionism because he or she does not want cheaper foreign textile products to come into the United States. The less foreign textiles imported into the United States, the more likely it is that the domestic worker will keep his or her job.

2. An Iowa grain farmer may have mixed feelings. He or she may see free trade as a way to open up foreign markets to Iowa grain. But the farmer may not want foreign grain to be imported into the United States to compete with Iowa grain on the domestic market, and thus may favor a policy that protects his or her crop from competition.

3. A retired Florida homemaker would most likely favor free trade because of the lower prices it would bring.

4. A Detroit autoworker probably fears foreign car imports because they threaten his or her job. The autoworker would likely favor protectionism.

5. The bricklayer could have mixed feelings. He or she would benefit from the lower consumer prices that would result from free trade. But, if domestic industries suffer from foreign competition under free trade, they may not want to expand into new factories, and the bricklayer may not be able to find enough work. On the other hand, free trade would mean that new foreign companies would open branches in California, requiring more office buildings and new employees.

6. A Washington firefighter drawing a salary would probably favor free trade because of the lower consumer prices it would bring. His or her job is relatively safe, regardless of what happens to domestic companies in the area.

7. A Maine lobsterman would want to keep foreign lobsters out of the U.S. market and would therefore likely favor government protection of the fishing industry.

8. A Texas oil worker would probably want to see the government institute a protectionist policy with a tariff placed on foreign oil coming to the United States. This would raise the price of the oil he or she is producing, open up new domestic oil exploration, and keep the oil field worker in a job.

9. A migrant sugar beet worker would probably have mixed feelings. He or she benefits from low consumer prices brought on by free trade, but since most sugar consumed in the United States is imported, a high tariff on imported sugar would cause increased domestic production and keep the sugar beet worker on the job.

10. Students will have mixed answers. Their answers may likely be affected by where they live, where their parents work, and so forth.

Student Handout #4

Congress has the greatest responsibility and power in making the federal budget. It must approve all programs and appropriate the funds necessary to run those programs. Congress has the duty and the right under the Constitution to raise and spend money but is limited in that the president must sign appropriation and authorization bills; therefore, the two branches must agree on the budget. Members of Congress must also try to please their constituents—the people who vote every two years.

The **president** has the responsibility to present a budget to Congress that reflects the administration's programs and ideas. The president—the most powerful official in the nation—can negotiate with Congress to get the most effective budget for carrying out the administration's priorities. The president is limited by the Constitution, which gives spending and taxing powers only to Congress.

Federal agencies have the responsibility of presenting their budgets to the president while the president's budget is being prepared. The heads of the agencies can also testify before Congress, making a case for their budget requests. They are limited, just as the president is, in that Congress has the final say.

According to the Constitution, **interest groups** have no responsibility in the budget process but certainly have the power of persuasion to convince members of Congress to appropriate funds that would benefit their interests. Interest groups raise a great deal of money from individuals and groups they represent, and that money can be used to great advantage. Interest groups are limited by the sheer size of their task. They have to convince a majority of 535 members of Congress—some of whom have no interest in the cause of the interest group or perhaps even dislike the cause.

Constituents, like interest groups, can persuade their members of Congress to vote for or against funding of certain programs. Constituents are voters, and voters ultimately have the final word at the polls. Constituents are limited by lack of organization or political "clout" compared to interest groups or powerful businesses.

Student Handout #1

Economic Survey

Below are several statements about the government's role in the economy. Circle A if you agree, D if you disagree, or U if you are undecided.

1. The federal government plays a large role in the economy.	A	D	U
2. The federal government should play a smaller role in the economy.	A	D	U
3. The government should continue to pass laws requiring products to be safe.	A	D	U
4. Government safety laws drive up the prices of consumer goods and do more harm than good.	A	D	U
5. The economy would be more efficient if the government regulated it less.	A	D	U
6. Government regulations often stifle competition, thereby causing prices to rise.	A	D	U
7. If government did not promote competition, businesses would soon form monopolies and force consumers to pay whatever prices companies demanded.	A	D	U
8. It is unfair for the government to redistribute income by taking money from those who have it and giving it to those who need it.	A	D	U
9. Minimum wage laws do more harm than good because they drive up consumer costs.	A	D	U
10. Public goods such as highways, schools, and police protection would be less efficient in the hands of private industry.	A	D	U
11. Business regulations would be more effective if they were done by state governments rather than by the federal government.	A	D	U
12. Inflation and unemployment should be allowed to seek their own level without government regulation or interference.	A	D	U

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Student Handout #2

Campaign Speeches

Senator Jane Jones and Governor James Smith are running for president against each other. Senator Jones favors an expansionary fiscal policy, whereas Governor Smith favors a restrictive fiscal policy. Read "Which Fiscal Policy?" on page 27 of *The American Economy*, and write a half-page campaign speech for each candidate stating the reasons why the candidates favor the fiscal policy each advocates. Write each speech as if you were trying to persuade the rest of the class that that particular fiscal policy is best for the country. Use the back of this handout if you need more room.

Senator Jane Jones:

Governor James Smith:

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Student Handout #3

Which Trade Policy?

Decide which trade policy—free trade (F) or protectionism (P)—each of the following Americans would most likely favor and circle the appropriate letter. Then, in the space below each item, write a short explanation as to why you think that person would choose that policy.

1. An assembly line worker in a Georgia textile mill F P

2. An Iowa grain farmer F P

3. A retired Florida homemaker F P

4. An autoworker in Detroit F P

5. A self-employed bricklayer in California F P

6. A firefighter in Washington, D.C. F P

7. A lobsterman in Maine F P

8. An oil field worker in Texas F P

9. A migrant sugar beet worker in Colorado F P

10. A high school student in your state F P

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Student Handout #4

Making the Federal Budget

Refer to the section "Making the Federal Budget" in *The American Economy* as you complete this handout. In the first column, list the responsibilities and powers of each of the players in the budget process. In the second column, list the limitations of each of the players.

Major Players in the Federal Budget Process	Responsibilities and Powers	Limitations
Congress		
President		
Federal Agencies		
Interest Groups		
Constituents		

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Student Handout #5

A Framework for Examining Federal Budget Items

Name of budget item: _____

Answer the following questions in the space below each question.

1. What benefits would the United States get if this item were funded?

2. What benefits would my city or state get if this item were funded?

3. Does this item present any social values? If yes, what are they?

4. Does this item present any political values? If yes, what are they?

5. Does this item present any economic values? If yes, what are they?

I believe this budget item should be funded in the U.S. budget because:

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Student Handout #6

Plan for Reducing U.S. Trade Deficits

You are to develop and defend a comprehensive plan for reducing the trade deficit. To do this, you must evaluate the strengths and weaknesses of several approaches. Consider the steps necessary to implement the approach you were assigned and the factors that might make it difficult to make that approach work. This worksheet will assist you with your evaluation. Answer each of the following questions for your assigned topic.

1. What are the strengths of this approach?

2. What are the weaknesses of this approach?

3. How likely is this approach to be adopted?

4. What factors might block this approach from being adopted?

5. What would have to occur for this approach to be accepted?

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Student Handout #7

U.S. Economy Since 1985

Read the following statements, and then answer the questions that follow on the back of this handout.

Since 1985, Americans have:

- seen their government's gross debt nearly triple to around $5 trillion.
- seen their government's annual budget deficit drop $100 billion in four years.
- enjoyed a long period of economic growth and suffered through a recession.
- seen their productivity rate rise dramatically after years of low growth in productivity.
- experienced an inflation rate one-fourth of what it was in 1980.
- seen their nation post record trade deficits.
- experienced unemployment rates higher than 8 percent and lower than 5.5 percent.
- seen their government negotiate trade agreements that eliminated or lowered trade barriers on most products.

1. Do you think it is possible for all these statements to be true? Explain your answer.

2. What conclusions might you draw about the U.S. economy from reading these statements?

3. Is the U.S. economy better now than it was in 1985 based on these statements?

4. As a final exercise, rewrite each statement as if you were writing it in the year 2010 and the opening statement said:

   Since 1995, the United States has:

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As you have found, ***The American Economy*** *is an excellent resource for understanding how the government's decisions and citizens' choices affect the national economy. After all, good decisions begin with knowledge, and knowledge begins with good resources. One place to find good resources is the Close Up Foundation, publisher of more than 30 books, videotapes, and simulation activities, all aimed at educating the nation's most valued resource—its citizens.*

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Everyone talks about the national debt, but few understand it. Do you? *America's Growing Debt* explains how the debt has reached more than $3 trillion, defines the terms economists and the media use to report on the national debt, and examines the programs that absorb the largest number of federal dollars each year. Third in our Special Focus Series, this book also analyzes deficit reduction proposals by President Clinton, Ross Perot, and the Concord Coalition. A free teacher's guide is included.

1994. $6.95. **Free** teacher's guide.

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You can have the power to cut the national defense budget—or to make it bigger! You can also increase—or reallocate—spending for education in America! Reshaping the nation's economy is easy with *Slicing the Pie*, a new federal budget simulation activity that puts participants in the places of members of Congress, lobbyists, and concerned citizens. As they give and hear testimony, players will determine the fate of five key areas within the federal budget: education, national defense, the environment, Social Security, and Medicare. Everything you need to play the game comes in one convenient storage box—including a teacher's guide with complete instructions and background information on the federal budget process.

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